PANEL 1

Resolutions

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It is like old home week here. Most of you I have run into over a period of time over the last 10–15 years, and I must admit that it is a real pleasant surprise to see so many familiar faces out here today.

I want to welcome you to our symposium's first set of panelists who will provide some perspective and thoughts on how the FDIC and RTC resolved troubled financial institutions during the 80s and early 90s. Some of you who are not local and those of you who are local to Washington may have noticed where our symposium is located. This hotel is right across the street from Arlington National Cemetery which is probably the most famous cemetery in the United States. Now, many of you also may recall that in resolving and liquidating failing institutions, we used metaphors and analogies that were death related. We referred to open institutions having negative capital as the living dead. We described the role of receiver to the uninitiated as part coroner, part undertaker, and part executor. When you think about it, all of those descriptions actually are very appropriate.

Well, to wind down and complete this macabre metaphor, maybe we should view this morning's panel as a walk through the cemetery of failed banks and thrifts. When we pass memorials to specific resolution battles, let's reflect on the strategies that proved successful and the ones that were less so. We also should pause from time-to-time at individual tombstones to consider the unique circumstances of an institution's demise and its resolution.

Now, joining us for the stroll this morning, we have a very distinguished panel. Bob Hartheimer, Doyle Mitchell, Jim Montgomery, Jay Sarles, and Stan Silverberg. Bob Hartheimer, who graciously agreed to be a panelist after Harrison Young found out last week that he had to be in South Korea today, is Managing Director at the investment banking firm of Friedman, Billings, Ramsey & Company, and is a senior member of the firm's financial services practice. Formerly, he was the FDIC's Director of Resolutions and while at the FDIC, oversaw the sale of over 200 failed banks and the creation of five bridge banks during the early 1990s. Prior to joining the FDIC, Mr. Hartheimer worked at Smith Barney and Merrill Lynch as an investment banker, specializing in financial institutions. He earned a BA from Hamilton College, and an MBA from the Wharton School at the University of Pennsylvania.

Our next panelist is Doyle Mitchell, who is President of Industrial Bank, N.A., the second largest minority-owned commercial bank and the third largest minority financial institution in the U.S. Starting in the bookkeeping department of the bank founded by his grandfather, Mr. Mitchell has held positions in the accounting, loan, audit and operations departments of the bank. By 1989, he had been appointed Assistant Vice President, Commercial Loans and, in 1991, Vice President. In 1993, he succeeded his father as President of Industrial. Among Mr. Mitchell's other activities, he serves on the board and is president of the U Street Theater Foundation, and sits on the boards of several organizations, including the District of Columbia Chamber of Commerce and the American Institute of Banking. He received a B.S. in Economics, with a concentration in finance and accounting, from Rutgers University.

Next to Mr. Mitchell is Jim Montgomery. Mr. Montgomery is Chairman and CEO of newly-chartered Frontier Bank, and is the former Chairman and Chief Executive Officer of Great Western Financial Corporation and its principal subsidiary, Great Western Bank. Starting his financial services career over 40 years ago at Price Waterhouse, Mr. Montgomery initially joined Great Western in 1960 as Assistant to the President. He left in 1964 to become Director and President of United Financial Corporation, and then returned to Great Western in 1975 as President. Mr. Montgomery previously has served on the boards of the Federal Home Loan Bank of San Francisco and the California Chamber of Commerce, and served as Chairman of America's Community Bankers of America. He is currently a director of Freddie Mac. Jim holds a bachelors degree in accounting from UCLA.

Our next panelist is Jay Sarles. Mr. Sarles is Vice Chairman and Chief Administrative Officer of Fleet Financial Group and oversees strategic planning and acquisitions, Fleet's administrative functions, and the financial services lines of businesses such as Fleet Mortgage and Fleet's credit card operations. Mr. Sarles is also Chairman of Fleet Bank, N.A. Mr. Sarles is active in several philanthropic and professional endeavors, serving as Chairman of the Metropolitan Boston Housing Partnership, and is on the board of trustees of Lifespan, a Providence, Rhode Island based health care system. He received a bachelor of arts degree from Amherst, and attended the program for management development at the Harvard Business School.

Our last panelist this morning is Stan Silverberg, who has been an independent consultant since he retired from the FDIC 11 years ago as Director of Research and Planning. Mr. Silverberg started his career at the Bank of America, then worked at the OCC and Office of the Secretary of Treasury. He joined the FDIC in 1967 and worked on developing FDIC policies for deposit insurance and bank resolutions, and also supervised liquidation issues. Mr. Silverberg had the lead staff role in the Continental Illinois case. Stan earned a B.A. from the University of Wisconsin, a Masters and Ph.D. in Economics from Yale University.

I would like to thank the panelists for taking the time from their busy schedules to be with us today to share their perspectives on managing the crisis. But, before I turn the podium over to Mr. Hartheimer, let's take a few minutes to review resolution activity and some of the resolution techniques employed during the crisis.

As you can see on the screen to my right, and for those of you who may have trouble reading the slides, copies can be found in your symposium folder, the crisis period started out with 22 failures in 1980, of which 11 were banks and 11 were thrifts. The first jump in failures resulted from thrifts incurring losses arising from having to pay high interest rates on deposits and holding large portfolios of lower-yielding fixed-rate mortgages. Over 100 institutions failed in 1982, although these numbers include 40 mutual savings banks that technically did not fail, but received some form of open bank assistance, such as net worth certificates.

The next wave of failures between 1984 and 1987 was tied to energy and agricultural lending in the commercial banking sector, and real estate lending on speculative projects, particularly in the energy belt for savings and loans. However, here too the figures do not tell the complete story because included in the figures are 265 banks having concentrations of 25 percent or more of the loan portfolios in agricultural or energy-related loan products that survived as a result of forbearance programs.

In 1988, the sharp decline in oil prices, the explosive growth in real estate development, and banks' increased concentrations in real estate lending caused significant losses to commercial banks, particularly in the southwest, resulting in 279 failures, the highest number of bank failures since the Great Depression. However, total financial institution failures did not peak until 1989 when Congress passed FIRREA with its provision of funds to resolve the savings and loan crisis. Upon its creation, the RTC assumed responsibility for 262 institutions already placed into conservatorship. Another 56 were added by year-end, resulting in a total of 533 banks and savings and loans having almost $175 billion in assets failing in 1989.

Failure rates remained high in 1990, 1991 and 1992, as real estate problems spread across the country, particularly in the northeast and west. In fact, in 1991, 78 percent of total failed bank assets were from northeast-located institutions. Savings and loans that failed were more geographically dispersed, but there were concentrations of some large failures on the west coast.

By 1994, the volume of financial institution failures had dropped off to its lowest level since the beginning of the crisis. Only 13 banks and 2 savings and loans failed in that year. The resolution crisis was over, but the asset disposition crisis was still running.

Now, what types of resolution methods did the FDIC and RTC employ to handle the crisis? By far, the most common method was through a purchase and assumption transaction, or what we call a P&A. A P&A is a closed bank transaction in which a healthy institution, known as the franchise acquirer, purchases some or all of the assets of the failed bank or thrift, and assumes some or all of the liabilities, including the insured deposits. The franchise acquirer usually pays a premium for the assumed deposits, thereby decreasing the cost of resolution.

Now, there are many variations of a P&A transaction. For example, in a whole bank, all-deposit P&A, all the assets and all of the deposits are conveyed at resolution to the franchise acquirer. In a P&A with loss sharing, the franchise acquirer purchases certain asset pools in which the FDIC has agreed to share generally 80 percent of any losses from book value. Now, at the other end of the spectrum, a clean bank, insured deposit only P&A is almost identical to another resolution method known as an insured deposit transfer or IDT, as we call them. In both instances, only insured deposits and loans secured by deposits are transferred to the acquiring institution. The substantive difference between these two types of transactions really lies in the duties the acquirer must perform related to the transaction itself.

The FDIC and RTC used other resolution methods much less often. The RTC never used open bank assistance, although as mentioned earlier, the FDIC has used this technique in which a failing bank remains open or is merged, with FDIC assistance, to resolve problems considered to be transitory in nature. Deposit payoffs occurred infrequently and constitute only 7 percent of all resolutions conducted. In this transaction, after the institution has been closed, the insured depositors are paid either directly by the FDIC, or through a bank acting as a paying agent, the full amount of their insured funds. All assets remained in the receivership estate to be liquidated over time and fund the claims of the uninsured depositors and other creditors. Now, since the imposition of what we refer to as least cost, this type of transaction also serves as the baseline from which the costs of other resolution transactions are measured.

While that is a quick summary and review of resolution activity, I would now like to turn the podium over to our panelists so we can listen to their perspectives on managing the crisis. After all panelists have spoken, we will open up the floor to questions and answers. May I introduce our first panelist, Bob Hartheimer.

Bob Hartheimer
Managing Director: Investment Banking Division
Friedman, Billings, Ramsey & Co.

Thank you, Jim. I am pleased to be here and I think many of us in the audience and myself consider Harrison Young a friend and have great respect for what he did for the FDIC. My memories go back to his constant challenging of the structures and the methods of resolution that Harrison pushed us to create and to think about all to the benefit of the government and us as a whole. It is unfortunate he's not here. But, I guess he's in

South Korea and he's in the middle of raising money for a Thai bank, so he is carrying his experience internationally.

I've had a chance to look at some of the materials that are being prepared for the upcoming volumes, and I do want to congratulate the group at the agency for the work they've done. I have to say there are a number of things I had forgotten about. It has only been two years since I left the agency, but the material seems very comprehensive and I look forward to those publications.

Jim asked me to focus in 10 or 15 minutes here on four items that came into the work that I did in resolutions at the agency. So, I'm going to kind of dive into those and just give some of my thoughts. I'm not going to spend a lot of time describing them. I think everyone really understands what they are. The four areas I'm going to talk about are bridge banks, cross guarantee authority, least cost, and the FDIC or government acquiring an ownership interest in failed institutions.

In bridge banks, I guess what I believe about bridge banks is that they were and I think will continue to be a very important tool for the FDIC to use in certain situations. It allowed our team to receive higher values for every bank and it's unfortunate that Crossland is not technically a bridge bank, but for all of us who worked on Crossland, we all believe it is a bridge bank, but it has a different structure. It was a conservatorship, but for all intents and purposes, it was a bridge bank. Every situation we went into where we created a bridge, where we ran the bank, saved money for the fund, and it also, I think, assisted the community that the bank was in. In some cases, it avoided decimation of the institution and its employees, but primarily it saved money which was our first objective. In the case of Crossland, I believe there would have been about $1 billion of additional loss; some of the people here remember when Crossland failed, we had two very ugly bids, one from Chase and one from Republic. Republic tried to buy Crossland three different times. Their bid, if I'm not mistaken, was $5 million and they refused to manage one asset, which actually is what put us over the edge in terms of creating this bridge because we couldn't walk into a situation and immediately manage the assets, and Chase's bid was only for half of the deposits and it really was not optimal. But, that created the opportunity to re-invent bridge banks which John Stone, Bill Roelle and Roger Watson and others had created and executed in the late 80s.

I also think it is the same with First City. The second time, I wasn't around for the first time, but I believe that the orderly manner in which we handled First City as a bridge allowed all the bridge banks to be sold and make so much money for the government, and in fact, created a lot of work for the legal division in terms of the lawsuit that First City entered into because there was money left over.

I believe that bridge banks should not become the norm. Many banks can be sold without a bridge and I understand there was a failure a couple of weeks ago—proud that it included loss share. That is something I'm not going to talk about, but it was an area we spent a lot of time with and there were those who believed it couldn't be done in small banks and I understand it was a $40 million bank that sold with the loss share—

that's great. But, in a situation like that, you can get your arms very quickly around the institution and be able to sell it contemporaneously with a sale or with a failure.

As we all know, there has been criticism of the government competing with other institutions while managing a bridge, and I actually think that is absurd. I think that is an academic argument or an argument of journalists to create some controversy in their publications. The bridge banks that we controlled and oversaw the management of, we never managed them ourselves, we were very conscious of the fact that we did not have experience in running banks. We hired good people to run banks. We directed them very distinctly, not to compete effectively on rate, and to essentially just take the institution, determine how to best organize it, and work with our group in Resolutions to sell it. I think the criticism was ill-founded. Those are my thoughts on bridge banks—with only 10 or 15 minutes, you can go on and on with these topics all day.

Cross guarantee authority—I actually was not at the agency when cross guarantee came into being in 1989, but I believe it is a very important tool, right up there with FDICIA in terms of its importance. It is unfortunate that when the cross guarantee authority came into being, we had a banking system that was essentially uneven around the country. We had states like Texas that had grown up with large chains of banks and that really caused for messier resolutions, but it effectively allowed the government to avoid taking the bad pieces of these chains of banks and watching managements of those banks move bad assets and things into those banks. The use of the authority was effective in two different ways. It was effective in allowing us to take healthy banks along with failed banks and as we think back to First City, there were really only two banks at First City, maybe a third—I really didn't study First City before coming here today—but as I remember, we were able to sell almost all of the 20 First City banks as whole banks without any assets passing to the agency, and that really was useful to offset the value of the bad banks that First City had in Dallas and Houston.

And I think people really understand why it makes sense to take the healthy banks at the time of resolution. There were a few situations where there were healthy banks that were sisters or brothers of failed banks, and the decision was made at the time of the failure of the unhealthy bank not to take the sister bank, and that also can work. There was one situation in Maine called Coastal Bank, which is around today, it was a wholly owned sub of a bank called Suffield—it might have been a savings bank or thrift in Connecticut—and Suffield failed before I got to the agency. I don't really know why Coastal was not taken at the time, but it turned out that Coastal ended up surviving, and today is doing very well. We got involved late in the process, the RTC and the old Division of Liquidation were involved in trying to determine the way to resolve Coastal, because of course the FDIC believed it owned Coastal. But, that was enough leverage to get Coastal to come to the table. A very creative resolution—it really wasn't a resolution but a creative transaction that was developed which went to the board of the FDIC and ultimately a lot of money was moved from the equity position of Coastal to the receivership of Suffield without having to take the bank. So, I think this tool can work in both ways. The FDIC doesn't have to be so quick to take healthy banks if it can figure out ways to use the leverage of the law to gain the value without necessarily having to sell. A very important tool—almost obvious for all of us that went through Resolutions 101 in the early years and hopefully it never goes away.

Least cost—I guess least cost was my least favorite requirement, and probably that is shared by others here. I think least cost was only loved by the GAO and others who tried to reduce every decision to an analytical decision. As many of us know, resolutions is not a science. There isn't a script that you follow. It is really an art and everyone is different and it is very difficult to come up with a least cost analysis, yet I had to sit before many FDIC boards and explain assumptions. I want to thank many of those boards for being flexible and understanding and believing in the assumptions that we came up with—some of which were a little creative—but if they weren't creative, you would have found that you wouldn't be able to have been creative in some of the resolutions that were done. Ultimately, I think we came up with good assumptions that had their basis in logic and in what was expected to occur. Many of those assumptions did occur and I think as the materials will come out in this next volume, you'll see that the costs of resolutions were generally at or below what were the least cost assumptions at the time. Having said that, it was not a fun thing to do.

I also think it virtually eliminated the creativity that Wall Street was responsible for in terms of open bank and early resolution assistance. Many people spent a lot of hours trying to figure out how to resolve First City. We can talk about that—the lawsuit is over. There is a lawsuit out, I've been told I'm being deposed. It hasn't happened yet, thankfully, for Meritor, but many banks tried to save themselves, as you might expect it being human nature, before failure. Once least cost came into being, you essentially couldn't compare the cost, you couldn't auction a bank before it failed and come up with a creative open bank solution. So, you usually had one group sponsored by bank management and in some cases bank management was suspect and in other cases they weren't, but you couldn't ever really compare that to anything. So, we had trouble convincing the FDIC board that those open bank solutions would be the least cost solution. It stifled creativity and so I'm mixed on my feeling of least cost.

The last thing I will just mention is the topic of acquiring an ownership interest by the government. As you might expect, I'm fairly enthusiastic about this and I hope the agency does this going forward. I think history has shown that when there are a lot of failures, prices are reduced. There are not a lot of buyers, and it is very little value that you are giving up at the time of resolution for the insurance fund to take an ongoing position. It is important for that ongoing position to be a neutral position from a management standpoint. There were great criticisms of Continental and of First City the first time—that the government position somehow had some influence in managing the institution. I can tell you that in Continental's case, I was involved very late in the resolution process—I was involved in the sale of the securities the government held, and I remember Holly Rademacher who was the CFO complaining to me that Roger Watson wouldn't tell him a thing about how to run the bank and they were upset about that. I actually think that was good of Roger to do that because that is not what the government's role should have been. Yet, the government played a significant role in creating the value that the shareholders ultimately received for Continental and there is no reason that the government shouldn't share in that value.

In the case of the thrift, American Savings Bank, the government had a 30 percent position. We thank Jim Meyer and his colleagues for creating an unbelievably complicated transaction. Once the FDIC was convinced about the sale of ASB, the government's position was initially estimated to be $200 or $300 million. Washington Mutual acquired it, the value at that time was $400 million, and ultimately when the position was sold, it was worth $600 million. That is really a lesson in—except for managing of the assets and the assistance agreement—there is really no direction by the FRF of how to manage that institution. That is really great to see a structure work like that.

So, I'm very positive. I would like to see more of it. I'm afraid that in the near term we're not going to see too many resolutions. It is somewhat a shame there is so much more enthusiasm and now so much more understanding about how to handle these things and I think we would all like to see this chapter happen again, but I guess there are others in the country and on the Hill that wouldn't want to see that.

Those are my thoughts on those four items. I would be happy to talk to you in the Q&A if anyone has any questions, and I would like to turn it over to Doyle.

Thank you.

Doyle Mitchell, President
Industrial Bank, N.A.

Good morning. I will approach this from Industrial Bank's experience in going through the resolution process, and then also try to point out some things that I think are very important to a lot of the communities in which we typically do business. In doing so, hopefully I will address branch breakups and interim capital assistance and other issues that were relevant to us as a minority bank participating in the process.

I want to thank the FDIC for holding these symposiums and in particular, recognize Former Chairman Helfer in holding these symposiums after the crisis is over. Hindsight is 20/20, but only if you look. I think it is extremely important that we go back and do that and prepare for the future, if necessary.

In 1993, I participated in a session at the National Bankers Association, the minority bank trade association, where individuals from the FDIC or other consulting firms explained to us what was happening in the thrift industry.

At the time, I had been President about six months at Industrial Bank. We had established a fairly assertive vision for the bank, where we thought we would someday establish branches in regional areas around Washington, D.C. I had no idea it would happen nearly so soon. So, in September or October, we started to investigate the thrifts in our area that were going to close and how we might be able to participate. We actually closed on two branches of one of the thrifts in June of 1994, long before I ever thought we would acquire branches in Prince Georges County, Maryland. I knew Prince Georges County, Maryland was an attractive area. It had a lot of the flight of the middle class from Washington, D.C. into that county and is an attractive market for our institution.

The transaction did become very complicated on a number of different fronts. The first front being that we had a Washington, D.C. charter for our bank, although we were regulated by the Comptroller of the Currency, probably the only one of that nature in the country. And, the thrifts that we wanted to bid on were in Prince Georges County, Maryland. If you recall, that was about the time that the whole interstate banking debate was starting to heat up and although the RTC did have intrastate and interstate branching override authority, the interstate branching authority was something that they did not want to touch, and I can understand why. It was being actively debated in Congress at the time.

So, we had a problem. We had a District bank and we had branches that we wanted to purchase in Prince Georges County, Maryland. The transaction from the crisis standpoint was small. From our standpoint, it was fairly large. We were looking at two branches that had about $40 million in deposits. We were about $190 million in total assets at the time.

I think the difficulty came as we looked at the benefits under the minority program in the way the law was originally crafted. I think that there was good intent on the part of Congress to recognize that there had to be some protection of services in low- and moderate-income neighborhoods and minority neighborhoods of banking services which typically seem to decline after an acquisition. But, along with the least cost test, which I think is always notorious in these acquisition situations, there was an inherent conflict in the way the law was documented. It presented a lot of conflict right within the Resolution Trust Corporation itself in how to interpret that, and actually how to implement it. I think those involved in the resolutions process wanted to protect the services in minority neighborhoods. The lawyers said there was a least cost test, so there was a constant conflict. I would urge that if there is any future legislation, that it be carefully crafted so that those conflicts don't occur in the future.

Now, why a minority program? I think from our experience at the bank, it's clear there is a need to protect banking services in low- and moderate-income areas, and those areas which tend to typically be predominately minority populated. We have over 60 years in areas that have been neglected and underserved by mainstream financial institutions. We've been able to do well. Four of our seven branches in Washington D.C., out of a total of nine, are in low- and moderate-income census tracts in Washington, D.C. We have learned it can be labor intensive to serve those markets that do not fall into the mainstream of financial services. But, at the same time, we have found that we can make a profit and also uplift those particular communities.

Well, let me kind of move on and discuss some particulars. For us, serving those communities is important and for those who live there, we are an important part of that community. And although we can't, at this point, do it on a national level and we don't hit the charts, if you will, in terms of large statistics, other minority banks around the country do the exact same thing. That is why you see so much objection when our institutions close or are looking to be sold to non-minority institutions, or why you have public debate when major institutions close branches in those neighborhoods, particularly in this case after an acquisition.

One of the things that we think worked very well was the branch breakup. It allowed institutions like ours to look at individual branches within a branch system. In this case, we bid on John Hanson Federal Savings and Loan, which had approximately nine branches. At the time it was resolved, it was about $150 million. The branches were spread out from north of Baltimore to southern Prince Georges County, Maryland. And, for an institution like ours, we had a focus on only 2–4 branches. We ended up choosing two that we thought we would bid on. And although I believe the efforts were to sell John Hanson as a whole institution, later it was broken up by branch. You could bid individually on branches, clusters of branches, or the whole institution and I believe the deciding factor probably was the least cost test.

In that vein though, I believe by breaking it up, you got more interest from community banks that wanted one or two branches. They had a branch on the eastern shore and I believe a community bank down there purchased the branch on the eastern shore. We had no interest in it, but a bank operating on the eastern shore certainly did. In the end, it probably brought a greater premium to the RTC by breaking the branches up and offering them in a number of different ways, either in clusters, per branch, or as a whole institution. So, I think that is something that works extremely well. I think it is something that all community banks would like to see in the future. Our branches that we targeted, obviously, were much more valuable to us than they would be as part of a whole bank resolution. I think that has the effect of raising the premiums.

The second thing that I believe has the effect of raising the premiums is the minority institutions program itself. For those branches that have a particular interest to us that others may not have, has the effect of raising the premium to the RTC and FDIC.

There were a number of benefits that we were able to take part in. There was in the law a “preference” and I say that in quotes because it was essentially zeroed out by the least cost test. But the way it was implemented was if a minority institution bid within 10 percent of a bid of another institution, the minority group was allowed to go back and re-bid. We won one of our branches hands down. It was that valuable to us. It was a branch that had some office space and we bid very aggressively. The other one we were able to purchase from the core acquirer.

Interim capital assistance was a good program for those trying to establish new minority institutions in minority neighborhoods. It originally was designed for that purpose, to be short-term interim capital assistance. It was later expanded so that existing institutions could make use of it as well. We probably used about 25 percent of what we were actually eligible to take down. It came in the form of a note and we were very risk adverse. We raised about $1.1 million in our own capital and took a million dollars in the interim capital assistance, which we will pay off when the time comes.

It was a good provision. It was a smart move to expand it to existing institutions because although it was intended to develop new banks, there were not a lot of new groups coming together to take advantage of some of the resolutions in those neighborhoods. There were some that were successfully created, but our position had always been that we, as existing institutions that were profitable and sound and that had been operating in these neighborhoods for a long time, could probably do a better job.

It proved a little true in the acquisitions process when there was a minority group out of Connecticut that wanted to actually buy all of John Hanson. The short story was that group came forward and made a bid that they could not actually close on, and much to our displeasure, we had to bid on it twice. There was a second round of bidding in which we increased our bid particularly for that one branch that had the office space.

It did prove as to why the ICA was useful not only for short-term interim capital for new institutions, but for those that had been in existence for awhile.

We were able to purchase loans, which was another very attractive part of the program. We sold some of those loans. I'll talk to you a little bit about the accounting treatment under the sale, and we were able to occupy the entire branch on one of those owned facilities "rent-free." I put that in quotes because the way we had to treat it from an accounting standpoint, there was some and is some existing amortization costs to that.

In terms of what our accountants did, we weren't real happy, but we went along with it and, in the end, it was a more conservative approach, but it benefited us more so than taking short-term benefits. We made a small profit on the loans. We didn't get rich on any sale by any stretch of the imagination. Our auditors did not allow us to book a profit. What they did was add it to, as part of the premium. They took all of the benefits that we had under this minority program—and I think this was an excellent way to treat it rather than to shoot for the short-term benefits, such as occupying the branch on a rent-free basis for five years. They assigned a value to all the benefits under the program and said we must amortize them over the period that applied, which was five years. So, we're writing that down. Of course we had to write it down as core deposit intangibles and core deposit values, and they also incorporated the profit on the sale of the loans. They actually looked at the discount and made that a segment of the premium, or actually deducted it for capital purposes as part of the premium. So, we didn't get the short-term profit benefits from that, but what we did get was an immediate impact to tangible capital from that treatment.

That is really the conclusion of my remarks and in summarizing, I think the important thing is that we all recognize the importance of financial services in low- and moderate-income areas. They can be very difficult to find for those in those neighborhoods. We just opened a branch in Washington, D.C. in what I would consider a moderate to middle class income neighborhood—a very stable bedroom community in Washington, D.C. where the home ownership rate is probably well over 60–70 percent. But, ironically, we are probably the only one of two branches within that neighborhood. There has been a lot of consolidation. There has been a lot of branch closings, and actually the building we are in was the home of Meritor Savings when they were taken over and eventually the acquiring institution left. That is what our mission has been—to serve those particular neighborhoods where those individuals need financial services. That is how we've made our niche. That is how we've made money. They handle their business very well. So, I would encourage going forward, that the programs are crafted with the branch breakup as a way to resolve institutions. I think there probably should be a study conducted on branch closures in minority neighborhoods, and a study on the public policy benefits of offering benefits to any institution that may want to acquire branches in low- and moderate-income neighborhoods. Again, I would also be happy to take questions when we get to the Q&A. I'll turn it over to Jim at this time.

Jim Montgomery, Past Chairman
Great Western Financial

Thanks very much. It is nice to be with you this morning. It is not a terribly pleasant subject to me that we're discussing this morning. I lived through the thrift crisis in the 1980s in this country, a lot of my good friends flew over the cliff, and it was not a pleasant thing. But, it is important, I think, for all of us to look back on that time and learn some lessons and make sure we don't repeat a lot of mistakes in the future.

I was asked to cover three subjects, dealing with the RTC, entire franchise deals and acquiring a franchise after conservatorship. I'm probably an expert on these subjects. I think we were probably, if not the RTC's number one customer, pretty close. Quoting from our 1993 annual report, "Since 1990, Great Western has completed 12 acquisitions totaling $14.2 billion in deposits." The names on that list are kind of interesting. The largest thrift failure, Home Fed of San Diego we acquired the remains of. The two most infamous thrift failures, Lincoln Savings with Charlie Keating in California, and Centrust Savings with David Paul in Florida, the remains of those two institutions became part of Great Western. It was an interesting time. It helped our company but that is the hard way to do it.

We involved ourselves in a lot of the activities that resolved thrift problems, including the management consignment program, which hasn't been mentioned. We did lend some of our senior officers to institutions to help work out problems. But, I want to spend a minute on one resolution program that we at Great Western did not take part in. I think it is a very important thing to look back on. I haven't seen it discussed a lot in the reflections on the thrift crisis and I think it should be focused on. That is the early resolution program adopted by the thrift industry with the help of the Federal Home Loan Bank Board and the then-FSLIC. That was the acquiring of one thrift by another using a technique called purchase accounting. Let me just give you some numbers.

As was mentioned earlier, the early thrift crisis was an interest rate crisis. There weren't troubled assets as such, but thrifts had a lot of fixed rate loans on their books and were paying more for deposits than they were receiving for loans. So, they were going broke with literally no problem assets. I think it's interesting that Great Western was one of the few major companies in the thrift business that did not take part in this resolution process of using purchase accounting. One of the reasons it's interesting is because I created the technique to do this. It was originally called the Montgomery Plan. I was sitting in a meeting of our trade association around 1980. We were all reflecting on how we could deal with this interest rate crisis in the business and how could we induce the healthy institutions to acquire the failing ones. Well, with my accounting background I was working on a process that, as I say, eventually became the Montgomery Plan. Under purchase accounting, most of you probably know you mark the assets of the acquired company to market. In this case, we're talking about a loan portfolio.

Let me give you some specific numbers because this is actually a case we were working on in Florida. A billion dollar institution, a billion dollars in deposits, essentially a billion dollars in loans and no net worth. Their net worth had disappeared because of the losses. Now, the loans were worth about $700 million in the marketplace at that time because they were at very low interest rates and we were in a double-digit interest rate environment. If you acquire that company, you mark the assets to market, which is to write them down to $700 million. The offset to the transaction is not to charge net worth, but to create a goodwill account under purchase accounting. Now, if you mark the assets to market, the technique that was allowed was to amortize that discount into income over about seven years. Accounting literature at the time allowed you to amoritize goodwill to expense over 30 years. So, look at the implications for your financial statements. You amortized the discount on loans in the income—about $45 million a year for seven years. What is hitting your expense account is $10 million a year because you're amortizing the expense over 30 years. The Montgomery Plan said that taking that example, the FSLIC's cost of resolution should be $300 million, because that is the difference between the assets and the liabilities. But, if they were to, in effect, fund the amortization of the goodwill over 30 years—in other words, write a check to the acquiring institution for $10 million a year each year for the 30 years, everyone would benefit. The government would spread out the cost of their resolution over 30 years, the institution that is doing the acquiring would have seven years of very good income stream under which it could restructure the assets of the acquired institution, and I thought everyone would benefit.

The reason that we didn't use the program is because it was changed in one very important way. What the government said is, we'll allow the write down and the creation of the goodwill account, but we won't fund the amortization of the goodwill. It was at that point that I erased my name from the Montgomery Plan. My point was, if I acquire deposits of $1 billion that I have to pay out at par, and I acquire assets of $1 billion that are worth $700 million, I've paid $300 million for that transaction, regardless of what the accounting says. So, we said we wouldn't do that.

It was an interesting thing that happened during that time. We created $27 billion of goodwill on the balance sheets of the thrift industry in the beginning of the 1980s through this accounting technique. Now, did that cause the thrift crisis? Certainly not. Did it add to it? Yes it did, because, what you had was a seriously undercapitalized industry growing on a rather thin tangible capital base, and what happened afterwards is a lot of bad assets were created by people like David Paul and Charlie Keating, who got a hold of these institutions with very little capital investment and then we had the second wave of the thrift crisis, which was the asset-based problem. It was a much larger problem because this technique allowed time buying for institutions, and a lot of things happened in the 1980s that were not very pleasant.

It is interesting that when the seven-year period ran out towards the end of the 80s and there was still a lot of goodwill on the books, that is when a lot of failures took place. That is not a coincidence. It is something that I think is interesting to look back on and I'm frankly surprised that I have not seen this discussed very much in the literature about the thrift crisis. Now, maybe it is in the studies that we're being presented with this week. I hope so, because I think it is a very important lesson to be learned.

To bring it up to date, I was interested when I picked up a newspaper about six months ago and read that the required capital for a new thrift institution had been reduced from $3 million to $2 million. I found that rather curious and I wondered why that took place. This comes at a time when the cost of deposit insurance to an institution, new or old, is essentially nil. I wonder why we would want to capitalize institutions at a relatively small amount, times are good, things are wonderful, and I'm not predicting another crisis in the offing, but I think the most important thing we have to have in our financial institutions is a strong capital base. The line of defense between the crazies and the insurance fund, if you will, is having people with their own serious money at risk. So, I'm a little surprised that we reduced that capital requirement to where it is.

We are capitalizing a new thrift institution, which was mentioned, Frontier Bank in Utah. We are capitalizing it at $6 million and I think that is a lot more sensible for an institution. I just think it's important to look back. Do I blame the Federal Home Loan Bank and the FSLIC? No. I think it was kind of a smart move on their part because what they were able to do was resolve a lot of cases without writing any checks. From their standpoint at the moment, it probably made a lot of sense. The problem was, without tangible capital, those institutions really were not able to make it, even under lower interest rate environments, without doing a lot of risky things. And we have seen the results of that.

I remember results very well and people tend to blame the regulators during some of this crisis. Well, I testified before Congress at the beginning of the 1980s saying that the unlimited use of brokered deposits in the deregulated world was going to be a disaster. I'm sorry that I'm as right as I was, but think about it. It was the first time in the history of the world that we would insure the cash flow of a seriously undercapitalized institution with very few questions asked. Now, where were the examiners? Let me tell you—you can do a lot of mischief between examinations, if you can pick up the phone and ask Wall Street to send you as much money as you want, put it in hundred thousand dollar increments, and pay a higher rate than someone else.

I remember in the old days, under rate control, we all paid the same rate and we could only have 5 percent of our deposits from money brokers. We said two things at the beginning of the 1980s. You can pay anything you want to for deposits and you can get as much as 100 percent from money brokers. We had an institution in California that grew from zero to $2 billion literally overnight and lost it all. Now, that can all take place between examinations, so you can't really blame the regulators. The reason I remember this particular example so well is that this institution had no retail branches, one office on the second story of a building, and got all of their money by telephone. That office happened to be the second story of a Great Western building, and when the T.V. focused that evening on this great failure, all you could see was the Great Western sign.

These are important things to remember. We ought to be very vigilant to make sure that we don't forget these lessons of the past, and repeat them in the future.

Thank you.

H. Jay Sarles, Vice Chairman
Fleet Financial Group

Good morning. I would like to read you a couple sentences from a December 1992 Harvard Business School study to set the stage for my remarks.

"At 5:00 p.m. on April 22, 1991, the tension at Fleet Financial Group headquarters was palpable. By the end of the day, William Seidman, the Chairman of the FDIC, would announce the name of the firm that would win the right to acquire the failed Bank of New England. To Terry Murray, Fleet's Chairman and Chief Executive, acquiring BNE in an FDIC-assisted transaction would be a strategic coup. BNE held solid Massachusetts and Connecticut franchises that Fleet needed to become the dominant, super-regional commercial bank in New England. Furthermore, the transaction would be low risk to Fleet, the FDIC would take ownership of all BNE's nonperforming assets. Murray had stitched together a partnership with Kohlberg, Kravis & Roberts (KKR) in record time to raise the capital that Fleet needed to make a serious bid. The only question was whether the FDIC would find it more appealing than the bids submitted by Bank of America and Bank of Boston."

Needless to say, as history bears it out, we were the winning bidder.

What I would like to do this morning is spend a little time giving you our view of how it happened, how it worked, and why it was successful.

To give you a little bit of history, the Bank of New England failed in January 1991. A bridge bank was established immediately thereon. From February to April, the FDIC ran a due diligence and bidding process. The deal structure, as indicated, was a good bank/bad bank. The good bank would be divested of all nonperforming assets, including a right to put future nonperforming assets. There would be a bad bank created that either the bidder in a separate transaction could manage, or another party could manage. We were the successful bidder, as you know, in April of 1991 and the actual transaction closed in July of 1991.

What made it work from our standpoint? It was very attractive from a financial standpoint. In the short term we enjoyed guaranteed earnings from the good bank and we had fee income from the bad bank. Furthermore, it gave us the opportunity to build a very strong franchise in New England. So, it wasn't just earnings; we ended up with a tremendous franchise in New England. Finally, we could minimize the risk because we had the right to put to the FDIC any assets that turned bad over the next three years. So, in a time where there was tremendous risk and tremendous uncertainty, we had an ability to get rid of those bad assets. We could clearly determine what our risk was and it was an operating risk and not a loan loss risk. Because of the reasons outlined, the transaction gave us the opportunity to attract almost $300 million in capital from KKR.

The way the transaction was structured, Fleet Financial Group was the purchaser, but we had raised money from KKR—$283 million. Initially, KKR wanted to structure a joint venture with Fleet—a 50/50 joint venture to purchase Bank of New England. Through five days of negotiation, we convinced them that would not be a successful way to win the bid nor to manage the company, and we convinced them to invest in Fleet, thus enabling us to bid on Bank of New England. But, they were concerned because while they were getting a clean bank with Bank of New England, they had Fleet to deal with and we had our own problems. So, they came up with an innovative structure, Dual Convertible Preferred. Essentially, they made a $283 million investment in Fleet. They were in a position either to convert that up into Fleet shares, 22.5 million Fleet shares, or down into a 50 percent interest in Bank of New England. The downward conversion, which is something neither of us wanted to happen, was there in case Fleet had problems. It would give them a 50 percent interest in a clean bank and preserve the value of their equity investment.

The prize was obvious. It was a $15 billion bank with a very strong franchise. We [Fleet] and KKR invested $500 million in capital to capitalize the bank. We ended up with $200 million in annual earnings out of this, after 18 months, or essentially a 40 percent return on our equity. KKR made an investment in Fleet of $283 million. Today it is worth $2.25 billion or a profit of $2 billion.

Now, to be fair about it, obviously there has been a tremendous run-up in bank stocks. But, if you look at it from when they invested the money to when we renegotiated the downward conversion out, their investment essentially went from $283 million to about $1.0 billion. They received about a 35 percent compounded return. For those of you who would be interested, that compares to a 17 percent compounded return for the S&P 500 in the period.

From our standpoint, it gave us the size, the earnings, and the capability to grow into the $100 billion financial institution we are today, the tenth largest bank in the U.S. in terms of size and market capitalization. Without the Bank of New England deal, we would not be where we are today.

What made it work for Fleet was our experience in mergers and acquisitions and our ability to get costs out. Short term, what drove this deal for us was we received a clean bank, we were able to get $350 million in costs out, and we convinced the FDIC that Fleet could make the transaction work. Obviously, getting a clean bank put us in a position to have strong earnings, a major help to Fleet at the time. We also got fee income from the RECOLL subsidiary. Without question, much of the quick turnaround and the profit was because of the turnaround in the economy, fueled by lower rates. But, it was clearly something where because of the structure and because of our capabilities in mergers and acquisitions and cost savings, we were able to turn it into a winning situation in a short period of time.

Looking at the transaction from the FDIC's point of view, three things were accomplished for the FDIC. First, they got a quick resolution of a large bank failure. It was six months from the time they put it into receivership until the time we took ownership of it. This obviously freed up their resources to deal with the continuing issues that were confronting the banking business. One-third of the financial institutions in New England went broke in this period, so there were obviously a lot of call in terms of their resources. Also, it returned the management of the bank to the private sector.

Secondly, it attracted new capital to the banking sector in the form of KKR's $283 million investment. Third, and most important in my view, by the structure they came up with, by putting it in the hands of a New England bank, it really went a long way to helping stabilize the New England banking environment. I think that was key, from the regulatory standpoint, because Fleet was now in a position to lend money again. We were in a position to support the local economy at a time when it desperately needed it.

For the next couple of minutes, I would like to just touch on one of our subsidiaries—RECOLL. As part of the BNE transaction, we ended up forming a subsidiary called RECOLL, which entered into a five-year contract with the FDIC to manage BNE's bad assets. This operated independently from the bank. Tom Lucey is in the audience. He was picked to run this operation and he toiled over the next several years with the FDIC to make it work. It was a big job. He was handed $6 billion in assets on the first day of the job—with no company, no people, etc., other than the people at the Bank of New England. We put an additional $750 million in assets into that subsidiary during the next two and one-half years.

How did RECOLL work? On the next slide you can see it was a wholly-owned subsidiary of Fleet. Its sole purpose was to manage and liquidate the bad bank. At one point, we had 1,200 employees. I think the structure that the FDIC came up with was innovative and worked very well. Essentially, we got paid, as a percentage of net cash collected, and that was defined as actual cash collections, less interest expense and less two times the expenses. We got paid starting at 1.5 percent and it could run up ultimately to 26 percent, depending on how much we collected over the period. We never got to the 26 percent. We got to 18.5 percent and as I said totaled about $140 million in fee income over three and one-half years. So, from that standpoint, it worked very well.

Interestingly enough, we had no public policy issues in terms of the acquisition of Bank of New England—the good bank—but we did have a lot of issues in terms of RECOLL in New England. It goes, in my view, to two things. One was the collection philosophy—a liquidation approach. The FDIC is charged with liquidating these assets at least cost to the fund. So, at a time when New England was struggling, businesses were saying, we don't want liquidations to happen, we want support. So, there was a tension between the businesses and ultimately the politicians and the FDIC mandate. Secondly, RECOLL was obviously incented to collect those assets because it was only cash that counted. If you restructured the loan, until you sold that loan, you didn't get paid. So, there was a feeling that RECOLL was out there liquidating as fast as possible in order to make a profit. In the political environment, that was a tough one. There are a number of people in this room who worked with us. We went to hearings before the Senate and the House and we dealt with the staffs of various New England Senators and Representatives. It was a tough political environment.

One of the things we learned early on was that just saying no wasn't going to work. We set up a group in RECOLL that did nothing but deal with the staffs. We had a hotline with the FDIC to deal with any issues that they got. Most importantly, we came up with an innovative structure which Mitchell Glassman and I worked out. This was the "soft seven" portfolio structure. Those were loans that were classified, mostly loans to small businesses, but they were loans the businesses were paying interest on, were current on, and the only reason they were classified was because there wasn't enough collateral to support them. Fleet bought those loans out of RECOLL and took them back into the banking system. The FDIC was innovative enough to realize we needed to do that. We bought $780 million of them, but the FDIC gave us the right to put them back if they went bad over the next three years. That program was an enormous success in terms of taking assets in liquidation and putting them back into the banking system. It basically went a long way in dealing with the public policy issue. Once we put that program in place, then the number and volume of complaints came down dramatically. As I said, I would give the FDIC enormous credit for their flexibility and for their understanding of what had to be done.

Finally, in terms of lessons, I believe this was a very good private/public partnership between Fleet and the FDIC through this period of time in terms of structuring the deal, working out the deal, working with RECOLL. They were innovative and they were flexible. I wasn't necessarily a believer then, but I have become a believer that the accelerated asset disposition process in cleaning things up is the right way to go, I think we've seen that in terms of how quickly the financial system bounced back.

One last thought: you need to be politically sensitive. You can't operate in this country without understanding that and responding to both economic considerations and political considerations. Fleet and the FDIC, I think, did a reasonably good job on that front. The economic recovery was a huge help. Without that, it would have been much tougher slogging. Much of what I have said here really goes to the fact that the resolution process has to be flexible to meet the conditions at the time.

I close with one last remark and that goes to this question of least cost. I just want to thank the FDIC for the creative use of least cost assumptions with regard to BNE.

Thank you very much.

Stan Silverberg
Banking and Economic Consultant

I'm pleased to be here and to have an opportunity to see some people that I haven't seen in a while, people that I've worked with and some old friends. I've been asked to talk about too big to fail, open bank assistance, and forbearance. That is a lot. Let me see if I can run through some of this fairly quickly.

First of all, it is hard to get excited about these things. We have had a strong economy and no significant failures for five years. We've eliminated competition from insolvent institutions and undercapitalized institutions. As a result, we've got record bank earnings and very high stock valuations. If we have a troubled bank, it is likely to be carefully examined by healthy institutions and snapped up without any assistance, unless it is substantially insolvent. I think that as long as there is a strong banking environment, there will be fewer failures, and most resolutions are going to bypass the FDIC.

Still, I think that we can't go on the assumption that there aren't going to be failures and some of these problems that we've dealt with in the past aren't going to come back. Otherwise, life at the FDIC is going to be very, very boring over the next decade.

Let me make a brief comment on forbearance. In principle, everyone, especially economists, hated it; but when it has been employed consciously with respect to groups of banks with appropriate monitoring, it has actually worked fairly well. Two programs in particular, the savings bank net worth certificate program and the farm bank program, both had heavy political support. My recollection is that Bill Isaac publicly opposed both of them and complained about them. With respect to the savings bank program, I think the FDIC staff felt that with appropriate restrictions on their behavior, that you could take an insolvent savings bank, make an assumption that interest rates were going to remain relatively constant, and factor in that long-term assets would appreciate as they approached maturity and that would offset some of the earnings losses. And then there were some benefits from a delayed resolution. The numbers actually led you to the conclusion that this really was not a particularly risky program, we didn't have to assume that rates were going to decline to make this program work out, and many of the savings banks in fact did ultimately survive and recapitalize. Some did not.

What conclusions can we come to from a forbearance program? Well I think, again, if it is monitored carefully and you don't let undercapitalized or insolvent institutions expand or behave inappropriately, under certain circumstances it seems to work. Whether it is something to happen and to be used in the future, that is hard to say.

I would like to mention that there was another very substantial forbearance program in the late 70s and the 80s. That related to the treatment of sovereign risk loans. Had the regulators insisted on realistic write-offs of Latin American loans, a number of the money center banks would have been in much deeper trouble than they were, and perhaps some would have become insolvent. That too was a situation where the delayed recognition of losses gave banks time to eventually work out of their situation. It is not as though those loans became good—earnings from other sources offset delayed write-offs. So, again, something that is hard to defend in principle, worked.

Let's talk a little bit about too big to fail. There are two questions here. One is, why do we do it? I think that is easier. And, what do we mean by it? And that may be a little harder.

I think the "why" is basically that if you have a situation where there are no good options to deal with a large failing bank, you've got to try to do something else. I think the Continental case stands out because concerns were real. There were, in fact, a few purchase and assumption possibilities. Not only would they have been very expensive, but I think they would have been subject to more political criticism than the transaction that ultimately occurred. The notion of paying off Continental was never a serious consideration. I think it is important to appreciate that the FDIC did not have the capacity to pay off a bank that size, and quite frankly, I don't think the FDIC today has the capacity to pay off banks with a very substantial number of deposit accounts, at least not without many problems. Perhaps I'm wrong and I would be interested in hearing about that.

But, the concern too was that any significant loss to depositors would have probably had substantial impact on a number of money center banks that were in serious trouble. I recall that when the loan was made by a number of New York banks at the time to bridge Continental's liquidity situation, the most vocal supporter of that was John Magilacutty at Manufacturers Hanover and for good reason. Our concern was that they were clearly the most exposed bank and would have experienced a substantial run if, in fact, some depositor losses were inflicted on Continental. Unfortunately, it was not a good time for a P&A transaction. Continental, at that point, had little franchise value. There were few interested parties. Prevailing rules with respect to interstate branching or permissible activities limited foreign interests, and while there was a possibility of changing the law to accommodate a domestic P&A, the general environment was not a healthy one. The more logical bidders were not in very strong condition.

I think that in today's environment, until we started to look at the top two, three or four banks, it would be hard to think of a need to do open bank assistance for a bank in Continental's situation. Continental was perhaps the 10th largest bank at that time. I think there are lots of options today. There are, perhaps, at least a half-dozen strong foreign banks as well as domestic banks that would give you options for a very large P&A transaction.

But, the other aspect of too big to fail is, are we willing to impose losses on depositors in very large banks and whether we have the capacity to do it? There had been some proposals in the past to haircut large bank depositors in the P&A transactions. I think I wrote one of those for the American Bankers Association several years ago. But, the FDIC has never seemed to be enthusiastic about those options. So, I think what too big to fail has come to mean is that by and large, we are not going to have depositor losses in the largest banks; and in fact, it is my impression that we probably have not had any depositor losses in any bank over about $2 billion. Also, I don't think we have had any losses to foreign depositors in any U.S. bank failure.

Is this a cause for real concern? There is obviously concern about fairness, that similarly situated depositors can be treated differently in different banks—competitive concerns that uninsured depositors in smaller banks are exposed to loss and larger banks are not. There is also concern that short-term practicality is going to undermine longer run financial market discipline.

What is the reality here? First of all, smaller banks and medium sized banks, actually hold very little in the way of uninsured longer-term deposits. In most bank failures, the amount of uninsured depositors by the time the bank fails tends to be very, very small. Actually, it's the larger banks where that becomes an issue because if you started out with 50 percent of your deposits uninsured, there is a limit to how much depositor flight you can absorb without the regulators stepping in.

As far as the question of discipline is concerned, I think there is enough ambiguity and uncertainty in the law so that depositors are still not going to feel that comfortable in a large troubled bank. The large depositor is going to feel exposed and he's going to try to get out. There are pressures on fund managers to get out. The behavior of the bank itself is going to be influenced by the fact that if it gets into trouble, it's going to have a liquidity problem. So, I think that whether or not we impose those losses, people behave as though those losses are going to be imposed and I don't think discipline is substantially undermined. I have to confess to having some ambiguity in my own feelings on this issue, and I'll come back to this.

There is also a lot of supervisory discipline that we didn't have before. We have risk-based insurance premiums. Not only is there a cost associated with it, but for a publicly owned bank, it is very easy to determine that a bank is paying a high deposit insurance premium by just looking at its financial statements. There is a greater willingness to pursue enforcement actions and again for a publicly-owned bank that is going to be considered a material event and require disclosure.

We've got improved data quality. The quality and speed of reporting is such that large banks have got to be very sensitive to the market implications of getting into difficulty. So, if there is a problem about not imposing losses on depositors in large banks, as a matter of principle, I don't think the actual behavior of the institutions is going to be dramatically influenced by that fact. Maybe a series of bail-outs of depositors in large bank failures will change that. But, at this point I wouldn't have great concern.

On the other hand, I do believe that on occasion, imposing losses on depositors has actually produced some positive results. When depositors at Penn Square were paid off, it got an enormous amount of attention. It had a substantial impact in the marketplace, and actually caused the Federal Reserve to ease interest rates at a time when Fed policy had probably been too tight. Occasionally that kind of market phenomenon can have a positive effect in terms of forestalling overly aggressive behavior. That was 1982. In 1983, there was an opportunity to pay off Midland Bank and Texas Bank. The Comptroller was reluctant to close the bank. The bank was not paid off. Eventually, there was a P&A. I have this vague feeling that if Midland Bank had been paid off, that some of the subsequent problems in Texas would have been reduced. Again, this is all hindsight and it is easier to look at something like this as a matter of hindsight. Also, it isn't clear whether it is the FDIC's role or whose role it ought to be to sort of shock the market and impose that kind of behavior.

Well, what about the future? I think that consistency is a nice thing to have, but the reality is that sometimes you have to depart from consistency, and I think the FDIC, by and large, has done that at appropriate times, and sometimes done it reasonably well. I think that the more serious issue when we talk about too big to fail relates to what about the three or four or so really big banks. Could we do a P&A with Chase or could there be a P&A connection with the forthcoming NationsBank/Bank of America combination? Maybe you can and maybe you can't, but I think the answer probably is that there are so many potential difficulties that policy ought to be geared so that it doesn't happen. What that probably means is perhaps more monitoring, perhaps a higher capital requirement or a higher threshold where enforcement action occurs. Presumably there is no great difficulty if a large, complicated institution is under pressure to recapitalize and sells off parts of its institution. It is a lot easier if that is done at an early stage than if it's done in connection with a failed bank transaction. So, I think the answer there has got to be that the best way to deal with it is to make sure it doesn't happen and to take the appropriate action to forestall anything that may be happening.

As a final comment, I'm also left with a couple of question marks about big bank failures. One is the ability to impose losses on depositors in very large banks. The other is whether there is any real system in place to deal with a situation where a large U.S. bank with foreign branches fails. Each country has its own rules. There are capital requirements that are imposed on foreign branches, and to assume that the FDIC would somehow be in control of a resolution, probably is not correct.

Again, I think those problems are so complicated that the appropriate strategy is to make sure they don't happen and to deal with those few U.S. banks that have sizeable operations abroad in a way to make sure that any potential problem is resolved well before failure is a possibility.

Thank you.

Wigand: At this point in the program, we're going to turn to our question and answer session. While the participants, meaning you in the audience, are perhaps jotting down some questions you may have, I'm going to follow-up with some comments that Stan made and ask questions of the other panelists and that is, what do you think about the too big to fail doctrine, particularly in light of the consolidation of the banking industry where we're going to have a fairly segmented banking industry in which we have many banks which are small and operate in community niches, if you will, and a handful of very large institutions, the likes of which this country has never seen. So, given that question, why don't we just go down the row. I think Stan has already given some comments on that, but I would like to hear what the other panelists have to say.

Hartheimer: I guess my view is that in this country since deposit insurance was created, we've enjoyed a relatively calm banking environment from the standpoint of the depositor. Notwithstanding that banks are getting larger and larger, I think that while no one at the agency would ever admit that too big to fail exists, it has to exist. It brings up words that I remember from a couple years ago, of systemic risk and contagion and all these great, interesting words. But, I don't think there is discipline in the market that would really ever believe that this government would let Travelers/Citicorp fail. I think you have to take that along with the fact that it is a consequence of enjoying depositor protection. So, I believe it effectively exists, but you would never really know it until you and John walk up to that little conference room off the Chairman's office to say, well, we have a problem. How are we going to handle it?

Mitchell: From my standpoint, the doctrine obviously works counterproductively to community banks. We see a lot of people who limit their deposits to $100,000 and may not do so at other banks simply because they know that doctrine exists. At the same time, the issue for the FDIC to consider is that it insures essentially all deposits under that doctrine.

The problem with it also, the third thing is that it doesn't encourage that discipline. So when someone, a business and/or an individual, is placing their money in a financial institution, they have to be remotely concerned about the general health of that institution. Usually these failures don't come overnight. They can be forewarned. I don't think it encourages that kind of market discipline that I think should exist.

Finally though, if there was such a policy, it could force deposits out of the banking system altogether and even though it may not be fair to community banks, that is not something I think we as community banks would want to see either.

Montgomery: We're going to open Frontier Bank on June 1st. I think by year-end, we will be too big to fail. I don't want to belabor this. I agree with what has been said before. I think you don't telegraph it in advance, but in fact there are banks that are too big to fail and we're just not going to let it happen.

Sarles: I would agree. With the very large banks, they probably are too big to fail. I think you go to Stan's point. You've got to make sure that they are very aggressive in maintaining capital in those banks so it limits the chance of a failure. You need strong supervisory involvement if problems happen to try to begin to think through what you need to do and basically prevent it from happening. Third, I think you need to begin to think through changes in the Federal Deposit Insurance approach. While that probably is an anathema with the politicians, I think with the changes in the financial services business that we need to begin to address that and determine whether something like that is absolutely necessary for some of these large banks. Maybe it is only necessary for banks under a certain size. I think we need a debate on that. In my view, one of the greatest disasters that happened was because of brokered deposits. The problem that Jim said should have been a small problem was magnified by growth from brokered deposits. We allowed banks that were community banks with $15 million in assets, that might have grown to $100 million and after failure could cost you $10 million. Instead they grew to $2 billion in six months with brokered deposits and cost the fund $300, $400 or $500 million. The brokered deposit situation has to be changed.

Wigand: All right—thank you. Now, it is going to be the participants', the audience's turn. We have several people placed throughout the room with microphones. Do any of you have any questions for our panelists?

Joseph: My name is Milton Joseph. This is really a question for Mr. Silverberg, but I think perhaps Mr. Montgomery might have a thought on this. It is a thrift related question. During the early 80s, without being redundant, obviously the problem was systemic interest rate environment and the whole host—no need to repeat all that. But, to me, one of the real tragedies of the thrift industry was Financial Corp. of America—the Charlie Knapp situation. He was the granddaddy, really, of what turned later into the real thrift problem, the credit quality problem. When Knapp was allowed to merge with American, which was really sort of a sleepy but not a problem high net worth ratio S&L, he got the ability to really go forward. I was just wondering, what motivated, in Mr. Silverberg's opinion and perhaps Mr. Montgomery's opinion, the federal regulators to allow somebody with that kind of background who really typified what was wrong with the S&L industry to gain the ability to run an institution of that size, which ultimately created a real thrift catastrophe?

Silverberg: Without commenting on Charlie Knapp, perhaps Jim will, I would just say that you had a situation where the industry was dramatically undercapitalized. I would be much more critical of the regulators. I think that there was an attempt to grow out of the problem. There was an unrealistic assessment about the benefits of commercial real estate lending for institutions that had no experience in the area, and that turned out to be the worst possible time to get involved in the activity. But, I think that when you come down to it, the Bank Board didn't have the funds and they weren't getting the funds from Congress. It was like trying to keep a lot of balls up in the air with the hope that somehow a combination of lower interest rates and other events would bail them out. But, it really was sort of a classic case of rolling the dice when you are trying to deal with too many insolvent institutions.

Montgomery: Charlie was one of a number of flamboyant operators in the business at the time and there was a lot of cheerleading going on from Wall Street and other places about that situation. One of the things that I've always found very strange, we did some studies inside Great Western when we were working on this so-called Montgomery Plan. There was a prevailing thought that the business was the victim of high interest rates, and once interest rates came back down, these seriously undercapitalized institutions were going to be okay. Our studies showed that wasn't the case. You couldn't make one of those things turn around, no matter how low interest rates got, unless you did some very crazy things on the asset side of the balance sheet, which is what happened in a lot of cases. There was a lack of understanding of the fact that once an institution's capital was gone, that capital base was very important not just for safety but for earnings, and they didn't have enough of a spread type of income available to them from traditional thrift activities to take an institution that didn't have capital and make it viable. I think the misunderstanding of that situation caused a lot of people to incorrectly think you could grow away from this problem. While you can see some interesting, dramatic results in some institutions on a short-term basis, it didn't seem sustainable and it turned out not to be.

Burdick: I'm Glen Burdick from A.E.W. Capital Management. A couple of the panelists, particularly Bob and Jay, touched on incentives, I think from both the public sector and from the private sector, and I think both in a positive way. To follow-up on that question, I would be interested in the panelists' perspective on whether the incentives that the public sector, i.e., the FDIC, received under various programs generally were fair, appropriate, and are there particular things, if we get into this situation in the future, are there particular areas where incentives may be better focused from the public sector?

Sarles: I think the challenge at the time for the FDIC was to attract capital into the system and to deal with an onslaught of problems and so forth. So, I think what they were trying to do with a combination of their own thinking, Wall Street, etc., was to come up with different ways and different means of incenting people to put capital at risk or to get involved. That is to their credit. I think that part of the problem is that because it is a public entity and because of this, you've got a doctrine of least cost and all the rest of it, there is a conflict there. I'm all in favor of a process that at least puts it out to a bid-type situation and offers incentives because I think that works best in attracting capital in this country and attracting management. The more you can do the better. The difficulty is that the minute you begin offering an ability to wheel and deal, you're going to have people second-guessing saying, oh, they didn't follow this rule, or oh, you didn't do this right—my God, haul them up before Congress and let's beat the living whatever it is out of them. That is too bad. There is a tension there. On the one hand, you want all the incentives possible. On the other hand, it isn't possible when you're a government agency. So, there is a line and I thought they did a pretty good job at it.

Hartheimer: In chatting with Jay before we all started, we were just talking about the banks Fleet bought. Jay had a comment which I thought was interesting. He said, yeah, it was relatively easy and then loss sharing came, and that was a little bit more difficult, which is a good sign, I think. But, it also tells me that while I'm a big proponent of incentives, I think the environment has to be right. When I got to the agency in 1991, with Crossland being the first real big one—I had gotten there right after New Hampshire had occurred and Southeast, and that was not an environment where incentives worked because there were no buyers and no one believed that the real estate world was going to turn around. So, I think that the agency has lived through and people here have lived through environments where incentives work and incentives don't work. I think you need to look at the environment and try to figure out whether you can push the envelope a little bit. If you have just enough bidders, then you layer in incentives. What was it—Michael Douglas said, "greed is good." It worked great for us in the early 90s when there were a lot of buyers. You could have the discipline of creating a structure, forcing bidders to bid only on that structure. It used to drive all of us crazy when bidders would lob in at the last minute a bid that was "nonconforming" and when the environment got better in 1992, we felt pretty good about saying you only can bid on this structure. But, it is the environment, I think, that drives the incentives and I think it has to first be looked at and then the agency should continue to push the envelope, as I believe they are doing.

Crocker: Don Crocker. There were at least four versions of the bridge bank. One was the Southwest plan, the bridge bank, the conservatorships, and also the management consignment program. Each one had a different approach to trying to figure out how do you keep this institution without losing all its depositors, without creating additional losses to the fund, and I'm interested in what the panel thinks of the best of the various versions for the future?

Silverberg: I think that there is obviously a distinction between the conservatorships which was just sort of a hold reaction in which the institutions could then be divided up and so forth and the bridge bank. Bridge banks became an option after I had left the FDIC. It was not an option, for example, with Continental. I always had mixed reactions to them. On the one hand, it would be nice if you could effect a clean transaction immediately without having to go through the bridge bank process and have the government involved heavily in that process. But the reality was that in a complicated transaction, it has been very hard to do.

Sarles: Our experience was very positive. I thought the bridge bank concept worked extremely well with Bank of New England. It worked because, in my view, there was a management team there. The minute we were picked as a bidder, we became involved and it was a short process to closing. What it did was it kept intact the franchise. It kept intact the customers, and that was a large part of what we saw in terms of the value. As long as the process is short, I think it can work very well and I think it is a terrific vehicle for creating the most value for the fund and for the ultimate buyer. What I'm not in favor of is having long-term ownership, in the public sector. I think if you want to get some of the upside, that it would be as an investor in the ultimate buyer of the bank, and not holding it from that standpoint. But, I thought the bridge bank concept worked extremely well. If they closed it down and tried to auction pieces, I don't think they would have done anywhere near as well in terms of recoveries. So, I'm a big proponent of it as a very workable solution.

Montgomery: I think these are all time-buying devices. I think they all work reasonably well. We had some good experience with a management consignment program. But, I just think any of those things should be tools to be used in the future to buy time until you can get a real resolution.

Mitchell: I would agree with all the comments, but since my experience is not extensive with it, I'll just defer to Bob.

Hartheimer: I guess as you think about each of the structures you mentioned, they all really came at different times in the crisis for different reasons. The conservatorships really were created because there was just a supply of failures that it was impossible to sell them off. So, it did buy time. The management consignment program, I'm not that familiar with, but my sense is it was really before the big crisis and it was a way to just forestall any activity at a time when the FSLIC had no money. Bridge banks—really the secret in all of this, when we talk about the protection of the depositor, that is a given.

What we found as the secret is how best you dispose of the assets because, until the last couple years, you couldn't imagine people paying anywhere near the value for deposits that are being paid today and people are paying upwards of 30 percent of deposits today. But, back in the early 90s/late 80s, you would pay 5, 6, 7 or 8 percent. But, there was a huge differential in the value of assets and the cost of assets. You could lose 20 percent of your asset value overnight if it wasn't managed right. So, I think these tools were really best used to manage the asset disposition and that is how they should be used going forward. I don't think you're going to see many conservatorships because it is unlikely that you will see the supply of failures. But, you should see bridge banks if you have complicated situations to take some time to figure out how best to dispose of the primary assets.

Murden: Bill Murden, Treasury Department. I have a two-part question on open bank assistance that I would like to follow-up on. Japan recently used open bank assistance for its banks in a way that is different from FDIC's experience. So, the first question is what the panel's views might be on the appropriate conditions that should accompany open bank assistance in terms of management and shareholders, etc.? The second, [what are] the pros and cons and the various forms of open bank assistance in terms of subordinated debt, preferred stock, asset purchases and so on?

Wigand: Are you directing your question to anyone in particular, or do you want to hear all panelists' views?

Silverberg: Anyone who has been through the process would tend to be very skeptical of open bank assistance, but if you don't know what the future situation is going to be and what the options are, maybe you've got to at least keep it on the table or under the table, as a possibility. If you've got an option of bringing in a new bank, bringing in new management and so forth, that is easier to rationalize. However, there have also been a lot of changes that make closed banks somewhat more attractive. Depositor preference, the fact that some of the provisions in FIRREA allow easier closure of branches and impose limits on existing contracts and so forth. There is some advantage to acquiring a closed bank rather than putting in assistance and having somebody else come in. But, again, I think there is a strong feeling in this country that if an institution has gotten into difficulty and become insolvent, the marketplace says it ought to go out of business.

Sarles: I'm not in favor of open assistance, but you may need that approach once in a while. If you use it, in my view, you wipe out the existing shareholders and management.

Montgomery: I don't have anything to add.

Mitchell: I would have to agree with the comments that were made. When a bank is on the verge of failing, it ought to be closed and prior to that is when management and the shareholders have their opportunity. So, they should be wiped out.

Hartheimer: I guess I would only add if you can attract a significant amount of outside capital, which would be in the first-loss position, I think you can find situations where that would make some sense. The problem is, there is never enough capital and there is always a differing view of the condition of the bank the examiners have. And in Japan, I'm not really that familiar with what is going on there, but my guess is that they have big problems and they need to be creative instead of just taking over all of these banks. If there are piles of money around the world that are kind of hovering to be invested, I think they ought to try and see if they can get those piles of money to be the first-loss positions, versus the Japanese Treasury.

Wigand: As you will note in your agenda for this symposium, we do have a panel tomorrow which will actually be talking about international banking issues associated with failures, you may want to ask this question at that time as well.

Comment: On open bank assistance, I might mention that we did have a program that worked pretty well, I gather, in the 1930s—the RFC. There was a use of preferred stock and bonds that helped capitalize banks that I gather were considered to be solvent. But, again, it was a program that I think hindsight gave fairly high marks to.

McKinley: I'm Don McKinley of the FDIC. Maybe this is for Bob and Stan, but when you look at the current legal environment of prompt corrective action, systemic risk, least cost test, and you look at the nature of the banking industry as it has changed, non-bank activities, bank activities, perhaps you have some type of assessment of the reaction time that the government might have in responding to that hypothetical large bank closing. How do you see the FDIC's ability in terms of reactive time as compared to the time we had in the past to respond to the large failures like Continental or First Republic?

Hartheimer: Well, I spent my Thanksgiving—I think it was 1994—courtesy of Chairman Helfer, preparing a plan for a big failure of a bank that had some derivative problems. I think that it's one of the situations for which you never can prepare enough, but we had a team of probably a dozen people that spent four or five days, we put a plan together. No one really expected this bank to have problems, but it was a good exercise—it wasn't great that it was over Thanksgiving. But, it was a good exercise to do. I think you at least outlined the things that you know you have to face when you get there. But, it is something that could be handled by the agency. You'll continue to go through trial runs, but I think it is just—it keeps the resolutions thinking young in a sense by continuing to think about how you handle derivative contracts or the sales of subsidiaries in non-bank activities and things like that. I don't think it is anything the agency can't handle if it happens.

Silverberg: I just think that the quality of available data and the quality of accounting and audit reports are much better than they were in the past. The speed and ease of access and so forth is much better. In the case of publicly-traded banks, I think there really has been a quantum improvement over the past decade.

Wigand: Unfortunately, that is all the time we have for questions. At this time, I would like to once again extend my thanks and I'm sure the audience would like to extend their thanks to the panelists for coming today. We certainly appreciate hearing their perspectives on resolution activity during the crisis years, and I think the comments that we've heard are very insightful.

We are breaking for lunch now. Lunch will be served in five minutes in the room right next door—the North Ballroom—and then we will be reconvening here at 1:30 for the asset disposition panel. See you then.

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