APPENDIX B

Resolutions Panel

The large number of bank and thrift failures in the 1980s and early 1990s created challenges not seen in the U.S. financial system since the 1930s. The FDIC and the RTC modified basic resolution strategies with an eye toward maintaining public confidence and financial stability, without sacrificing other public policy objectives. This panel focuses on the issues and strategies that arose in connection with these bank and thrift failures.

Possible Issues for Discussion

Too Big To Fail—The FDIC and other regulators' preference for solutions that favored stability rather than market discipline was apparent in the treatment of larger banks during the 1980s. The transactions in the early 1980s involving First Pennsylvania, the mutual savings banks and Continental Illinois set the pattern for the treatment of large banks throughout the rest of the 1980s. In large-bank resolutions, the FDIC used purchase and assumptions transactions, bridge banks, and open bank assistance agreements that typically provided full protection for uninsured depositors and other general creditors. This raised questions of fairness, since numerous small bank failures were resolved through deposit payoffs, in which uninsured depositors suffered losses. This was said to have created incentives for depositors to place large deposits in larger banks.

Forbearance—Forbearance, as practiced by the FDIC, exempted certain distressed institutions that had been operating in a safe and sound manner from capital requirements for a limited period of time. The first formal forbearance program was the Net Worth Certificate Program, which was established in 1982 under the Garn-St Germain Act. Other forbearance programs established for banks in the mid-to-late 1980s included a temporary capital forbearance program for agricultural banks and banks with a concentration of energy loans and the agricultural loan loss amortization program adopted by Congress in 1987. There are many risks in offering forbearance programs, and without proper oversight, forbearance can permit further deterioration and result in increased costs. The experience of the savings and loan industry in the 1980s when forbearance was applied broadly to the whole industry is a clear example of the problems associated with forbearance.

Impact of FDICIA—While the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 touched a wide range of regulatory areas, certain provisions—particularly those pertaining to prompt corrective action (PCA) on failing institutions and the least cost test—had profound effects on the way the FDIC conducted failed bank resolutions. The aspect of PCA that most directly affects the FDIC's approach to bank failures prescribes mandatory measures for critically undercapitalized institutions (those with a ratio of tangible equity to total assets equal to or less than 2 percent). In these cases, a conservator or receiver must be appointed no later than 90 days after the institution falls into the critically undercapitalized category. The FDIC may grant up to two 90-day extensions of the PCA period if it is determined that those extensions would better protect the insurance fund from long-term losses. FDICIA also requires the FDIC to pick the least costly resolution transaction available. All bids must be considered together and evaluated on the basis of comparative cost; other policy considerations cannot be factored into the determination of the appropriate transaction.

Ownership Interest—In several of the large bank failures in the 1980s, such as Continental Illinois and First City, the FDIC, as part of the resolution, took back stock and/or warrants as part of the deal. This resulted in the FDIC having an ownership position (in some cases a majority position) in the resulting institution. In most cases, this ownership position was later sold back to the resulting institutions. Some critics objected to the notion of a government agency acquiring ownership in a bank and considered it "nationalization." Others view this as an appropriate way for the FDIC to share in any "upside" potential given that it bears the "downside" risk.

Bridge Banks—A bridge bank is a temporary banking structure controlled by the FDIC to take over the operations of a failed bank and maintain banking services for the customers. As the name implies, a bridge bank is designed to "bridge" the gap between the failure of a bank and the time when the FDIC can implement a satisfactory resolution of the failed bank. Beginning in 1987, the bridge bank structure became an important part of the FDIC's bank resolution process for large banks with complex financial structures in danger of failing. The bridge bank provided the FDIC time to take control of the failed bank's business, stabilize the situation, and determine an appropriate permanent resolution. Many proponents of the bridge bank structure believe that the bridge bank structure will remain an integral part of large bank failures in the future. Some critics however have expressed concern that the government is running a bank and competing against other nongovernment owned banks.

Open Bank Assistance—The FDIC was authorized to provide open bank assistance (OBA) under Section 13(c) of the FDI Act. OBA was not used by the RTC. OBA transactions occurred when a distressed financial institution remained open with the aid of government financial assistance. Generally, the FDIC required new management, ensured that the ownership interest was diluted to a nominal amount, and called for a private sector capital infusion. OBA was also used to facilitate the acquisition of a failing bank or thrift by a healthy institution (e.g. mutual savings banks in the early 1980s). The FDIC provided financial help in the form of loans, contributions, deposits, asset purchases, or the assumption of liabilities. While minimizing cost to the deposit insurance funds was the ultimate goal, OBA was provided for public policy reasons, such as maintaining public confidence and maintaining banking services to a community. A major criticism of OBA has been that shareholders of failing institutions have benefited from government assistance. The FDIC moved away from OBA after 1988 as bridge bank authority gave the FDIC a more expedient and flexible alternative. Currently, in order for the FDIC to provide OBA, it must establish that the assistance is the least costly to the insurance fund of all possible methods for resolving the institution and insurance funds cannot be used to benefit shareholders of the failing institution. There have been no OBA transactions since 1992.

Cross-Guarantee Authority—The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 gave the FDIC the authority to assess cross-guarantee claims against banks that were affiliates of a failed bank. This was designed to prevent affiliated banks from shifting assets and liabilities in anticipation of the failure of one or more of their number in an attempt to retain value for the owners while depriving the FDIC of that value and increasing the FDIC's costs. The cross-guarantee authority allowed the FDIC to apportion loss among all the banks within the affiliated group in the event that one or more of the institutions failed. Since the addition of this authority, the FDIC has closed affiliated banks that would otherwise have remained open and has sold the entire group of affiliated banks at the same time.

Loss Sharing—The loss sharing transaction was designed to address problems associated with marketing large banks that typically had sizeable commercial loan and commercial real estate portfolios. Acquiring institutions had been reluctant to acquire commercial assets in FDIC transactions because of limited due diligence periods, poor or questionable underwriting criteria of the failed bank, and declining and volatile commercial real estate markets in the late 1980s and early 1990s. Under loss sharing, the FDIC agreed to absorb a significant portion, typically 80 percent, of the losses on a specified pool of commercial-type loans, with the acquiring bank liable for the remaining portion of the loss. By limiting an acquirer's exposure to a maximum loss of 20 percent, the FDIC hoped to pass most of the failed bank assets while still receiving a substantial premium for the deposit franchise. The FDIC also hoped to induce rational, economic asset management behavior.

Interim Capital Assistance—FIRREA mandated that the RTC attempt to preserve the minority ownership of failed minority thrifts. To achieve this objective, the RTC developed and administered programs for minority participation. As part of the program, the RTC provided interim capital assistance (ICA) of up to two-thirds of the required capital for the acquisition. Initially, these funds were to be short-term bridge financing but were later extended up to 5 years. These ICA loans carried interest rates equal to the RTC's borrowing cost, which was much lower than comparable financing. The use of ICA raised issues over public policy benefits versus least cost.

Advanced Dividends—An advance dividend is a payment made to uninsured depositors immediately after a bank fails, based on a conservative estimate of the value of the receivership's assets and a determination of the uninsured depositors' *pro rata* share of that value. Advance dividends were developed to reduce the disruption caused by a deposit payoff to uninsured depositors by providing uninsured depositors with greater liquidity.

Branch Breakups—In certain failing institutions, there have been few, if any, acquirers willing to assume the deposits of a multi-branch bank or thrift. This became a major concern to the RTC in the early 1990s as the large size of many of the failed thrifts and the general health of the banking and thrift industries limited the amount of interest in these institutions. In response, the RTC used the branch breakup transaction to increase bidder participation and competition, and add flexibility to the resolution process. The RTC marketed institutions through branch breakup transactions unless their accounting systems were incapable of handling multiple acquirers. Because the branch breakup approach enabled potential acquirers to bid on individual branch offices of failed thrifts, it appealed to a much broader group of potential investors. While the branch breakup was also used by the FDIC, usually when competition for the entire franchise was expected to be limited, it was used more frequently by the RTC. This process, which initially was used only in situations where there were few bidders for the entire franchise, became a means to enhance value through increased competition. However, certain disadvantages exist with branch breakup transactions. Electronic data processing costs are generally higher than in whole franchise transactions, and it is more difficult to complete transactions within the required timeframes. Branch breakups also require one of the acquiring institutions to be lead acquirer and provide backroom operations for all the acquirers during the transition period.

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