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BAILOUT

An Insider's Account of Bank Failures and Rescues

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PREFACE

FOUR PERSONS met behind closed doors for a few hours in the spring of 1984, they decided to do the largest government bailout in American history—the rescue of Continental Illinois Bank. At the time I thought how different this was from the fishbowl atmosphere at the White House and in Congress where I had participated in less far-reaching decisions This story is told solely from my perspective, I did not seek advice on whether to proceed from the other three participants—Paul Volcker, Bill Isaac, or Todd Conover

As I began sifting through my files in preparation for retirement, I decided to write this book to document for the first time how decisions that have enormous impact on the public are made by the bank regulators. Although secrecy is essential at the time of the transactions, it cannot be justified after the fact.

After the decision to write was made, I chose to chronicle the evolution of the essentiality doctrine, which derives from the statutory authority for bank bailouts. Initiated with the rescue of tiny Unity Bank in 1971, the doctrine was developed, expanded, and refined in two subsequent bailouts. Thirteen years later it was used to save giant Continental Illinois Within this framework, I discuss and describe all of the options considered in every bank failure, large and small I speak with authority, particularly concerning the rescues. No other principal participated in more than two of the long-term commercial bank bailouts in FDIC history I worked and voted on all four.

During the latter stages of the Continental crisis, at a particularly frustrating time in the negotiations, I felt the public should know not only the nature of our enormous undertaking, but the conflict of personalities and opinions among the negotiators that made our task unnecessarily difficult Oftentimes during our deliberations, we debated points that I thought had been decided earlier. I realized that I was subconsciously recalling earlier bailout battles in which I had participated

Continental was not merely a peak—it was a link in a chain that we had been forging since the 1971 rescue of Unity Bank. Other bailouts, of successively larger institutions, followed in ensuing years, there is no reason to think that the chain has been completed yet Indeed, new links in this less-than-illustrious progression can form with frightening speed, as experience has demonstrated

Early in my career the mission of the Federal Deposit Insurance Corporation (FDIC) was to do such a good job protecting depositors that they did not have to know anything about a bank except that it was FDIC-insured. That symbol of confidence on the door means just that. I was proud that the agency to which I devoted a good portion of my working life achieved its objective to a remarkable degree.

Then a new element came into play the abrupt and steep increase in bank failures in the 1980s. More Americans than ever before were suddenly becoming aware of the presence of FDIC and its handling of bank failures We were no longer some abstract federal guarantee. Our people were on the scene week in and out, taking over failed banks and taking care of insured depositors. Uninsured depositors, investors, management, stockholders, and delinquent borrowers got another view of FDIC in action It was very much at our discretion whether and when any person with more than $100,000 in a failed bank would receive any part of it. Delinquent borrowers suddenly found out that they were being pressed for collection. Directors of former banks found themselves sued for damages for neglecting prudent operation of their banks.

Most of all there was a hue and cry over the reality of different treatment between megabanks and small banks Nowhere

was this more apparent than in the Continental case when we announced in May 1984 that everyone who had money in the multibillion-dollar institution would be fully protected, regardless of the amount of insurance coverage The resulting uproar echoed from one end of the country to the other; it rang in the halls of Congress Particularly vehement were those newly educated the hard way—those people who had lost uninsured money in small-or medium-sized banks that we had handled without 100 percent protection for all depositors and investors. We were accused of discrimination in favor of large banks in the press, in Congress, and on the scene

Suddenly the bailout question assumed a vast new relevance. Not only was it a good story, an unknown story, that should be told; it had become important to show that we really had explored all the other options before going to the last resort—bailout. (Although I am now gone from the FDIC, I somewhat automatically interchange the words "we" and "FDIC" throughout the book) Therefore, my purpose is to illuminate what happened and why it happened. I hope to help a new generation of regulators and bankers learn from the lessons of the past. Even more importantly I hope this book will help raise public awareness of the pitfalls that can keep them from realizing the opportunities of the exotic new financial world of the 1980s

Although I had long mulled over the idea of this book, my wife, Margery, finally launched this project. I gratefully acknowledge this debt among many others to her I would not have committed myself to it without her quiet but effective urging, which no doubt stemmed from her desire to find a constructive outlet for the restless energy of a husband entering retirement after nearly thirty active, often hectic, years in public service. I—and perhaps she, too—owe a special thanks to Martin Kessler, my editor and publisher, who first encouraged me to write the book and then was unrelenting in criticism that made the final product better I wish here to also acknowledge

the many persons, within FDIC and without, who shared their recollections and observations with me and verified facts. To each I am indebted They are too numerous to list individually, but I would like to single out for special mention Alan R. Miller, my top assistant during the first three bailouts, Todd Conover, who generously jogged his memory for recollections of dates, incidents, and conversations, Frank Wille for his memories of how the two of us initiated use of the essentiality doctrine, Stan Silverberg, Mike Hovan, Mark Laverick, Peter Kravitz, and Roger Watson, who shared with me their recollections; Margery, who excised my split infinitives and made numerous other suggestions regarding grammar and punctuation; Sabrina Soares for her patient, friendly editorial assistance, and for his advice and assistance, Kenneth Fulton.

PART ONE

The Stage Is Set

Chapter II

The Legal Framework

The Law and the Regulators Who Interpret It

TO TELL the bailout story adequately we must first describe the incredibly complex mix of overlapping and sometimes conflicting supervisory jurisdictions, and the law under which the regulators labor In particular, we will show how FDIC operates

FDIC, the Federal Reserve, the Office of the Comptroller of the Currency, fifty state bank supervisors, the Justice Department, the Securities and Exchange Commission, the Treasury Department, the Federal Home Loan Bank Board, and the National Credit Union Administration, all have roles to play in regulating our financial structure. You will see how these roles often overlap as the bailout stories unfold The Bush Task Group[1] published the table information shown in figure 2 1 In

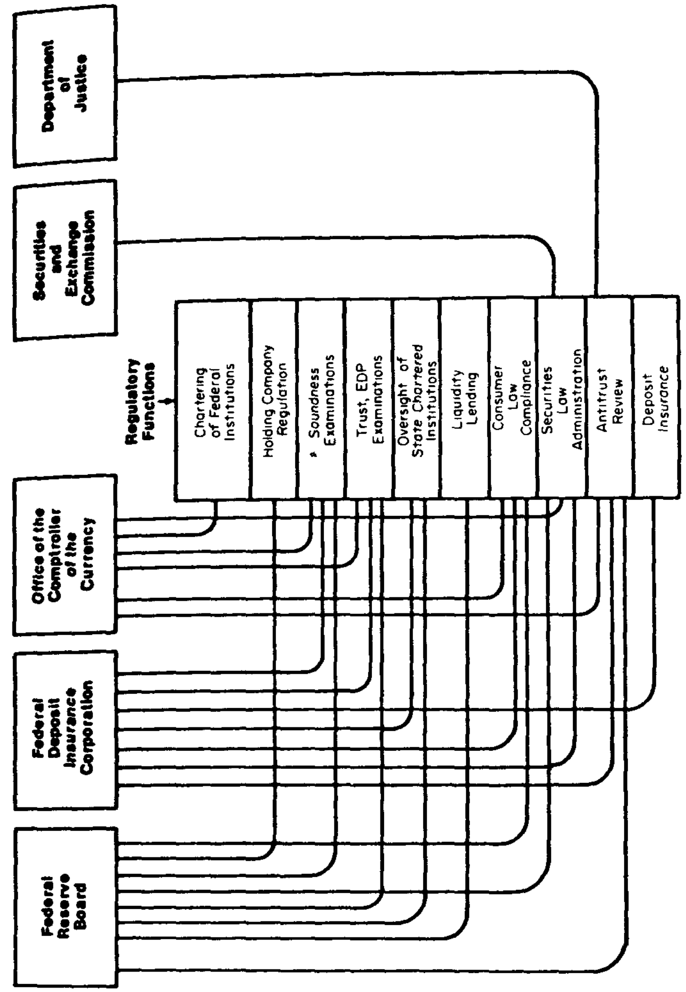

FIGURE 2 1

Functional Analysis of Existing Federal Bank Regulation

NOTE *Blueprint for Reform The Report of the Task Group on Regulation of Financial Services (The Bush Report)* (Washington, D C U S Government Printing Office, 1984), p 52 my opinion this maze of jurisdictional lines is a symbol of clarity compared to what really happens, particularly when state regulators, governors, and the administration become involved.

The glue that keeps all this confusion from disintegrating into total chaos is federal insurance—FDIC for banks, the Federal Savings and Loan Insurance Corporation for savings and loans, and the National Credit Union Share Insurance Fund for credit unions By far, the largest role is played by FDIC Customers of institutions that lack federal insurance can be devastated, as was demonstrated in the 1985 Ohio and Maryland crises among savings and loans without federal protection

Confusion is rampant When my wife, Margery, tells me she is going to the "bank," I know she is headed for the neighborhood savings and loan where she has her checking account. When the *Wall Street Journal* reports that FDIC has closed another bank, I know that either the Comptroller of the Currency or a state bank supervisor actually ordered the closing When a congressman asks FDIC to extend farm loans when a bank fails in his district, I know that the law is not understood even by many of the legislators themselves

The Bank Supervisors

The Federal Deposit Insurance Corporation is headquartered in Washington, D C , like the other Federals. Its gray granite, seven-story building on Seventeenth Street is a block from the White House FDIC insures 14,800 banks and of these directly supervises the 8,400 state-chartered commercial banks and 339 mutual savings banks that are not Federal Reserve members. FDIC has the lonely responsibility of deciding how to handle

failed or failing banks. Its board makes the bailout decisions

The home of the Federal Reserve System is on Twentieth Street, a few blocks west of the FDIC offices Like the FDIC, it is a member of the financial agencies' enclave and somewhat insulated from the political pressures of the White House The Federal Reserve System—or simply, "*the* Fed," as it is known—is a daily working partner of FDIC, particularly in time of crisis. It supervises the nation's 6,100 bank holding companies and the 1,000 state-chartered banks that have Fed membership

Even more closely related—although located several blocks farther away, south of Constitution Avenue in L'Enfant Plaza—is the Office of the Comptroller of the Currency (OCC) The comptroller is in the contradictory position of being responsible directly to the secretary of the Treasury for administrative matters and at the same time being a member of the independent FDIC board of directors in the financial enclave. The comptroller supervises 5,000 banks holding national charters The Treasury Department itself, located two blocks from FDIC on Fifteenth Street, has no direct role in bank supervision, but makes its presence felt FDIC communication with the administration is through the Treasury, whose head is a senior member of the president's cabinet.

FDIC, the Fed, and OCC share the federal custodianship for the nation's banking system Each agency employs field examiners who periodically conduct examinations of the institutions under their jurisdiction These examinations include a review of the loan portfolio and a check on policies and procedures In addition, the call reports filed with regulators four times a year by each institution are plugged into the agencies' computer systems, which kick out for further analysis any unusual numbers or deviations from industry standards * The agencies have the power to issue orders prohibiting banks from doing anything the regulators believe is unsafe and unsound FDIC alone

*Call reports constitute a balance sheet of the bank and contain vital statistics on a bank's financial condition and its current operating results has authority to institute proceedings for revocation of deposit insurance

The basic function of the three supervisors is the same Only the banks are different Many banks are owned by bank holding companies, most own only one bank, but some own several Within the same bank holding company banks of all three categories—national, state, and Fed member may exist. This further crosses jurisdiction among the regulators because each bank remains subject to its own supervisor, while the Fed is the supervisor of the holding company itself

Confusing? The varied and competing supervisory lines already make an unwieldy tangle. It promises to get worse. Interstate banking, which is developing rapidly, means that holding companies may soon own banks not only of different charters but within different states. Thus holding companies may become subject to *two or more* state supervisors as well as two or more federal supervisors

The foregoing summary covers only the federal banking agencies In addition, two doors up the street FDIC has a cousin that takes care of the 3,000 federally chartered savings and loan associations (S&Ls) The Federal Home Loan Bank Board (FHLBB) regulates them and through its Federal Savings and Loan Insurance Corporation (FSLIC) insures them * S&Ls are distinguished from banks in that they are still primarily home mortgage lenders, but the distinctions are blurring under recent laws that have permitted S&Ls to make loans for other purposes and to offer checking accounts If FDIC and FSLIC funds are joined together, which I oppose, the distinctions would have to be totally removed over time Many of the savings and loans are state chartered with no federal connection. Much of the recent savings and loan trouble stems from state laws that allow S&Ls to engage in risky endeavors, compounded by lack of adequate state supervision

An even more distant cousin is around the corner and down

*Confusion is intensified when, under some circumstances, federally chartered banks are insured by FDIC and supervised by FHLBB

the street from FHLBB The National Credit Union Administration guides those 18,000 specialized entities that have sprung up in American workplaces across the nation—including FDIC whose employees have long had their own credit union.

These five agencies constitute the financial supervisory establishment of the federal government Each also has its state counterpart, cooperation with state authorities is an integral part of the supervisory effort.

As charterers, the states and OCC have the sole power to declare any of their banks insolvent One widespread misconception is that FDIC closes banks It does not. It has no authority to do so. FDIC's job is to pick up the pieces after the bank has failed and, in rare cases, to save it from closing. As insurer, FDIC immediately handles the claims of insured depositors in a failed bank either through a payoff to depositors or by selling the bank, usually within one or two days or over a weekend As receiver, FDIC takes over all bank assets with the fiduciary responsibility to liquidate them, that is, to realize as much cash as possible and divide it among all legitimate claimants In a sale all of the deposits and some of the assets are assumed by the new owner.

How the System Got That Way

It has been said that the federal bank regulatory system is one no sane person would design That is true, of course, but the system was not put together at a single stroke, by a single person, or even a single group of persons It is the accumulation of 125 years of lawmaking Every bit of it has been an uphill struggle against longstanding public distrust of an all-powerful central bank At no time in that century and beyond would it have been possible to command the political support to enact a comprehensive system of bank and monetary regulation The system had to be created piecemeal, and each piece had to be wrested from an economic crisis serious enough to muster the support for enactment Significantly, anticentral bank forces prevailed for thirty years after President Andrew Jackson destroyed the Bank of the United States in 1832 The first element of the modern federal regulatory system could not be forged until the Civil War, which gave President Abraham Lincoln sufficient leverage to win passage of a law creating the Office of the Comptroller of the Currency as a mechanism to finance the Union forces. The comptroller, as the name implies, at first actually controlled the amount of federally authorized currency in circulation

Fifty years went by before the second regulatory body was established as the legacy of the Panic of 1907. The panic was an especially severe episode of the tight-money crises that periodically seized the nation in the absence of a dependable, properly distributed money supply A blue-ribbon study group, the National Monetary Commission, was established; on its recommendation Congress passed the Federal Reserve Act in 1913 Even then, concessions to anticentral bank forces made the Fed a decentralized organization of circumscribed authority with a vague mandate to maintain the sufficiency of the circulating medium

The basis of the sweeping powers the Fed can exercise today did not come until the next economic crisis—the Great Depression The same set of emergency laws that made the Fed genuinely a central bank also gave birth to the third star in the federal bank regulatory triumvirate—the Federal Deposit Insurance Corporation

The deposit insurance legislation was not initiated by President Franklin Roosevelt who, in fact, opposed it He and others were concerned that bank insurance would undermine market discipline and serve as an invitation to banks to speculate freely. The most strenuous opposition came from the American

Bankers Association, which feared federal intrusion into the banking business. Among the most outspoken of the bank opponents of a federal insurance system was Continental How wrong could they be?

As an accommodation to those who worried that insurance might foster speculation, Senator Carter Glass and other proponents agreed to an insurance limit of $2,500, enough to protect small savers who were the innocent victims of bank failures while still leaving major investors at risk. The insurance provisions were incorporated into the Banking Act of 1933, the banking centerpiece of New Deal legislation that stormed through Congress in the tumult of Roosevelt's Hundred Days. Better known as the Glass-Steagall Act, the landmark law among other things separated the riskier investment banking business from workaday commercial banking. The act also established the framework for the American financial services industry that stands to this day, although on increasingly shaky ground as lawyers seek and find loopholes in the law

The Glass-Steagall Act inserted the new insurance provisions into the Federal Reserve Act that seemed like a logical repository at the time They remained there until Congress gave FDIC its own act in 1950 (FDI Act).

FDIC's Independent Financing and Operation

From the first FDIC was designed to operate independently This meant that funding was independent of general tax monies and management was not beholden to the president or Congress. So FDIC, which opened for business January 1, 1934, was originally funded by a $289 million issue of capital stock subscribed by the Treasury and the Federal Reserve The 1950 FDI

Act followed by two years the final repurchase of that stock by FDIC and the severing of all financial ties with the Fed and the administration.

To this day FDIC uses no tax dollars and is not subject to the appropriations process in Congress.* It derives its considerable income from its assessment powers and from interest accruing on the insurance fund. The law authorizes FDIC to levy an assessment—in effect to charge banks an insurance premium—at a base rate of one-twelfth of 1 percent of domestic deposits each year. In recent years this "domestic" distinction has taken on vast new importance because it enables banks to escape assessment on billions of dollars in overseas deposits. It is a point I will return to with some emphasis later. The law also provides for refunds to banks of part of their assessments in years when there is little insurance activity. In the quiescent decades preceding the 1980s, banks became used to receiving back more than half their premiums. That has come to an abrupt halt in these recent years of escalating bank failure rates, and banks now consider themselves lucky if they receive any assessment rebate at all. In 1984 the effective insurance assessment was just under one-thirteenth of 1 percent or about double the rate of the preceding four decades. For 1985 there was no rebate for the first time since the rebate mechanism was established in 1950. There is a $1.1 billion insurance loss carryover from 1985, mostly due to Continental, so a rebate for 1986 is unlikely.

The federal deposit insurance fund itself, the financial centerpiece of the agency, is by law invested in U.S. Treasury securities. In 1985 income totaled $3.3 billion, including $1.4 billion from assessments and $1.9 billion in interest. Insurance losses and operating expenses totaled $1.95 billion.

*This freedom is now threatened with rulings that the FDIC is at least partially covered by the Gramm-Rudman-Hollings Debt Reduction Act, even though no tax monies are involved. A further threat, still unresolved, would take away the last semblance of independence by putting the FDIC into the congressional appropriation process, and place it under the thumb of the Office of Management and Budget (OMB).

Despite the enormous drains on the corporation in 1984 and 1985, the fund had grown to $17.9 billion at year-end 1985, up from $11 billion in 1981. When I first joined FDIC in 1968 the fund totaled $3.7 billion.

The FDIC fund has no relevance to the federal budget, but the president's Office of Management and Budget anxiously awaits the figures each year. The profits are used as a cosmetic accounting entry to show a reduction in the federal deficit.

Although FDIC is a full-fledged government entity, its management is separate and self-contained, not subject to direction from any other part of the executive branch. The corporation, as its employees prefer to call it, is run by a three-member Board of Directors. Unlike cabinet officers and certain other federal agency heads, FDIC directors do not serve at the pleasure of the president, each is appointed to a term exceeding that of the president. Two members are appointed to six-year terms by the president with the advice and consent of the Senate. The third director is the comptroller of the currency, an ex officio member appointed for a five-year term, in practice he serves at the pleasure of the president.*

The law specifies that not more than two of the three directors can be of the same political party. Usually, but not always, the chairman is from the president's party. For one example, I served as chairman under President Jimmy Carter, a Democrat, for two years and under President Ronald Reagan, a Republican, for seven months.

To this point, I have described the mishmash of supervision under which the nation's financial institutions must labor. Now it is time to go to the issue of bank failures. Here the picture is clear and simple. FDIC has the lonely responsibility for handling failing banks.

*The Comptroller of the Currency is an ex officio member holding the office because of his or her position as comptroller, not as an independently nominated member. In all other respects the comptroller is a fully participating board member.

Dealing with Failure

Life is unfair and this is never more true than when a bank closes or is on the brink of failure The way FDIC chooses to handle a failed or failing bank can have dramatically different impacts on depositors, customers, and the community This decision on how to proceed is based on the law, exercised with the discretion and judgment of the board

The board's three basic choices are. (1) pay off a failed bank, that is, give the insured depositors their money; (2) sell it to a new owner with FDIC assistance, or (3) *prevent* it from failing —that is, bail it out Ground rules for the decision are simple The law is clear. The closed bank must be paid off unless a sale would be less costly to FDIC The bailout is the rare exception, under certain circumstances, a bank can be prevented from failing regardless of the cost

In a payoff the insured receive their money promptly; checks in process bounce, the community loses the bank and its services, loan customers must go elsewhere, and uninsured depositors and creditors are at the mercy of the liquidation results In the sale of a failed bank—or a "purchase and assumption transaction" as it is known at FDIC—all depositors and creditors, insured and uninsured, are fully protected A new bank or branch replaces the old with no interruption in banking service, the closing of the failed bank goes relatively unnoticed in the community In either a payoff or sale, FDIC takes over the bad loans of the failed bank for liquidation and advances funds to cover the deposit liabilities Stockholders in either instance go to the end of the line, receiving some value on their stock only if the liquidation is spectacularly successful and all other valid claims have been paid first

Granted by a 1935 amendment to the deposit insurance law, the payoff and sale provisions have been the options used in over 99 percent of the failures through the years True, variations have evolved to meet special circumstances and the law has been tinkered with, but the controlling statutory language is virtually the same and the effect on depositors is unchanged

Bailout authority was added in 1950 and in 1982 the language was loosened somewhat so that the finding necessary to provide assistance is easier to make. The only other significant addition to the powers for handling a failed bank also came in 1982—the waiver of the prohibition against out-of-state sales for institutions at least $500 million in size, and a provision allowing for aid to keep a failing bank open if such assistance is cheaper than a payoff.

In a bailout, the bank does not close, and everyone—insured or not—is fully protected, except management which is fired and stockholders who retain only greatly diluted value in their holdings Such privileged treatment is accorded by FDIC only rarely to an elect few as you shall see as the story unfolds. Of the eighty* cases in 1984 requiring FDIC outlays, sixteen were payoffs, sixty-three were sales, and one was a bailout. In 1985 with 120 cases, twenty-nine were payoffs and ninety-one were sales By June 18 there were fifty-eight bank failures in 1986 Of these, forty were sold, seventeen were handled through some variation of a payoff, and one was given open bank assistance There were no essentiality bailouts in 1985 or the first half of 1986

The Payoff Procedures

What is now Section 11(f) of the FDI Act provides that "payment of the insured deposits shall be made by the Corporation as soon as possible " This is the basic insurance law and

*I include banks saved with FDIC assistance in the failure totals

FDIC is under no obligation to use any other procedure Everything else is optional and discretionary

Three variations of the payoff have been developed over the years (1) simply issuing FDIC checks to give to the insured depositors, (2) creating a deposit insurance national bank where the insured can collect their money, or (3) transferring the deposits to another bank that makes the insured money available.

Today, the direct payoff is only used when there is no other option, the deposit transfer is the preferred solution in payoff situations The payoff by deposit transfer is a hybrid. Not as bad as a direct payoff, not as good as a sale The insured depositors receive all their money immediately. Some of the loans are transferred to another bank in the community and in most instances an immediate advance payment is made to the uninsured, based on the FDIC estimate of the ultimate liquidation value Creation of a deposit insurance national bank to do the payoff is a rarely used procedure.

The Purchase and Assumption Procedure

What is now Section 13(c)(2)(A) of the FDI Act states that the corporation may sell the assets and assume the liabilities of the failed bank to facilitate a merger, but only if it is less costly than a payoff

Initially, the preponderance of bank failures was handled by the payoff procedure In the 1940s the FDIC board switched to a policy of effectively providing 100 percent insurance by handling all failures through a purchase and assumption transaction without closing the bank, regardless of the law or the circumstances. The deals were called "absorptions" since FDIC absorbed any losses. The new procedures were flagged in FDIC's 1949 annual report that expressed pride in providing

100 percent insurance in every bank failure for a five-year period. This prompted a storm in Congress because it had deliberately set the insurance limits low and contemplated payoffs as the primary tool to be used

During the 1951 hearings, Senator J William Fulbright sharply criticized FDIC for providing 100 percent insurance without regard to cost He showed that in one bank failure FDIC had announced full protection before it could have known what the cost would be That, he said, was at odds with the law authorizing FDIC assistance only when it would "reduce the risk or avert a threatened loss to the Corporation." He noted that FDIC had consistently provided such swift 100 percent protection in nineteen consecutive bank failures over a six-year span. The question of full protection had also come up the year before at hearings that preceded the passage of the FDI Act of 1950 Senator Paul Douglas suggested that FDIC's actions were creating "a moral obligation upon the Government to protect all deposits and not merely insured deposits."

FDIC took the message to heart and began to hew strictly to the cost test implied in the language "reduce the risk or avert a threatened loss." The result was nothing but direct payoffs for a number of years Then, gradually, the policy turned to shopping for a merger partner and consummating a purchase and assumption transaction immediately after failure. Bidding was not used, the arrangements were negotiated with a single buyer. The present policy of calling for competitive bids on the purchase of a closed bank started January 12, 1966, with the failure of the Five Points National Bank in Miami, Florida. The effect of this procedural change was to markedly increase the possibility of a purchase and assumption transaction because the premium received by FDIC serves to reduce the cost relative to a payoff

Language was added in the 1982 Garn-St Germain Act to remove any doubt that the cost test must be used. The new language says· "No assistance shall be provided . in excess of that amount which the Corporation determines to be reasonably necessary to save the cost of liquidating, including paying of the insured accounts "

In a straight purchase and assumption transaction banking organizations or individuals in the same state bid to assume all of the deposit liabilities and the good assets of the failed bank All customers' funds, insured and uninsured, become available in the new bank and FDIC takes over the bad loans The vast majority of all purchase and assumption transactions are handled in this manner Five variations of this purchase and assumption, or sale, procedure have evolved over the past twenty years, designed to meet special circumstances as they arose All the variations rely on the same provision in the law and have the same effect on bank depositors and creditors.

The variations are: (1) dividing the bank for sale to two parties, (2) sale to a foreign interest; (3) an assisted sale without going through the bidding process; (4) an out-of-state sale, and (5) a delayed sale following a cash infusion by FDIC

The Interstate Provision

We have seen how the standard sale procedure evolved over many years to the present almost routine system The interstate sale procedure, by contrast, developed quickly but with considerable acrimony and several false starts. However, the ground rules are now firmly in place

Early in 1980, faced with the certain failure of one large institution and very possibly others, I began pushing for legislation to allow the interstate sale of a large failed bank. Opposition was ferocious from the American Bankers Association, Independent Bankers Association of America, and the Conference of State Bank Supervisors Larry Kreider of CSBS told me he was going to beat the bill, but he might reconsider if I could tell him the name of a single big bank in trouble This, at the height of our struggle to save First Pennsylvania I declined his offer.

Finally, I enlisted the aid of Treasury Undersecretary Bob Carswell, who set up a working group of Fed Governor Chuck Partee, Comptroller John Heimann, Credit Union Administrator Larry Connell and me. Troublesome issues were· (a) the size cutoff, (b) should it be full interstate or regional, and (c) should there be preferences for same-type or same-state institutions.

We had to balance what we needed with what we could get from the Congress The compromise we worked out was finally adopted virtually unchanged as part of the Garn-St Germain Act of 1982 Key requirements were that the bank must actually fail, and it must have at least $500 million in assets

It was not until February 14, 1986, that an interstate sale was actually accomplished when the $593-million Park Bank of St. Petersburg, Florida, was sold to Chase Manhattan Corp of New York for $62 6 million, the fourth highest bid ever received * Four times previously we had embarked on an interstate sale, but for different reasons, none were accomplished.[2]

The Essentiality Doctrine

What is now Section 13(c)(4)(A) of the FDI Act gives the FDIC board sole discretion to prevent a bank from failing, at whatever cost. The board need only make the finding that the insured bank is in danger of failing and "is essential to provide adequate banking service in its community "

*The five highest bids Franklin National, New York, 1974, $125 million, U S National, San Diego, 1973, $89 5 million, United American Bank, Knoxville, 1983, $67 5 million (estimated), Park Bank, 1986, $62 6 million, First National Bank of Midland, Texas, 1983, $51 1 million

This essentiality option, the life-or-death bailout authority, is what this book is all about—the Unity, Commonwealth, First Pennsylvania, and Continental syndrome None of the numerous other applications for bailout have possessed the characteristics that the FDIC board believed would merit an "essentiality" finding.

The law and legislative history of the 1950 act provide no detailed directions on arriving at the essentiality finding. Nor do they define community The law does list specific kinds of assistance that are permissible to use in preventing a bank from failing But as to when to employ such aid, there are merely references to the "discretion" of the Board of Directors and the "opinion" of the board Clearly, however, this authority was not intended for widespread use.

The original draft of the legislation made no mention of essentiality. This prompted concern during Senate hearings that use of the new powers would not be restricted to banks in real distress and that it might conflict with the Fed's powers as lender of last resort Further, the Senate was aware of and concerned about the prior five-year history when FDIC protected all depositors and creditors by refusing to do a single payoff Following the hearings, the Senate Banking Committee added the requirements that an assisted bank "is in danger of closing," and that an essentiality finding must be made. The House accepted the Senate language that became law

It really boils down to a judgment call by the FDIC board; the courts have always upheld an agency's discretionary authority [3] The record shows this discretion has not been abused. In each instance careful, factual analysis preceded the action, formally adopted guidelines were followed, and no challenge has been successful So there you have it. A bank can be bailed out if two of the three FDIC board members determine it should be. In practice, the bailout decisions do not come easily and FDIC boards have been reluctant to make an essentiality finding unless they perceive a clear and present danger to the nation's

financial system Unity Bank of Boston is the exception. Although it did not threaten the nation's financial system, it posed other threats

As the story unfolds you will see that the bailout option is taken only after all other avenues have been explored and exhausted. merger with another institution, foreign or domestic, or sale to anyone interested and capable, be it a bank or individual When the other options disappear the choice then lies between a payoff and a bailout The bailout results differ in one significant respect from a payoff, sale, or merger. Of necessity, in a bailout there is some protection for stockholders and creditors If the bank is not allowed to fail, it is impossible to structure a transaction that does not provide at least the possibility of some residual value to stockholders and creditors of the failing institution

The FDIC Bank Failure Routine

Armed with the array of options and faced with an avalanche of failures in the 1980s, FDIC evolved a bank failure routine designed to let the staff operate with little board oversight in the ordinary cases, but to permit the board to become intensely involved in the large or complicated ones.

At the end of the FDIC regular board meeting, a "probable fail" list is read aloud by the chairman There is only one copy It is kept under lock and key

The list is updated weekly and contains the banks that have a high probability of failure over the next ninety days Banks go on the list based on reports by OCC, the Federal Reserve, a state supervisor, or FDIC's Division of Bank Supervision The complicated prospective failures trigger a lengthy sequence of analysis, meetings, and discussions on the best way to handle each case On occasion, the failure of a bank comes with lightning speed when a run develops as in Continental's case or when fraud or shady operations are discovered as in Penn Square's case Then the bank barely makes the list before it fails

After discussion of the ninety-day list, the Division of Bank Supervision is asked for a report on the expected failures during the current week In each case, two questions are always asked: First, can we sell the bank? Selling the bank is the preferred solution because it causes the least disruption in the community And second, when must the board members be available for the special meeting on disposal of the bank?

By this time preparations for a sale have been well underway They begin as soon as a bank goes on the ninety-day list Examiners go into the bank to prepare a bid package containing such information as the size, type, and duration of the deposit base, the volatile deposits that may run off, contingencies, such as standby letters of credit and other off-balance-sheet items; leases or loans on the bank buildings, pending or anticipated lawsuits, and anything else that is needed for a bidder to make an informed decision on possible acquisition of the bank An important part of the investigation is determining whether a sale will be cheaper than a payoff and thus permissible under the law. If the examiners discover fraud or suspect hidden liabilities, or anything else that would make a sale more costly than a payoff, FDIC goes directly into a payoff mode In all other cases, FDIC proceeds to a sale Sometimes this eventually leads to a payoff anyway when the conditions for a sale cannot be met

What is offered for sale is all deposit liabilities, insured and uninsured, together with the good assets of the bank, usually including the bank building itself and certain performing loans in the bank As part of the transaction, FDIC will advance enough cash to the successful bidder to balance deposits against

assets. What bidders offer is a premium for the franchise FDIC calculates the minimum it must receive in a premium to reduce the outlay below the payoff cost The bidders are not told what it is.

Then FDIC draws up a list of qualified bidders The ground rules set by the board call for inviting bids from well-regarded individual investors or banks located in the area served by the failed bank The institutions must be well managed, approximately twice as large as the bank to be acquired, and have adequate capital Further, FDIC checks to be sure that the purchaser will not be acquiring a monopolistic hold on the community. Individual investors must satisfy similar criteria. A few days before the bid meeting Paul Ramey, in our special unit that handles failed banks, goes over the options with the FDIC board, which then gives Ramey the go-ahead on how to proceed

The proposed list of bidders is circulated to the three board members, the Federal Reserve, and the state supervisor Any of these can remove a prospective bidder for cause The day before the anticipated failure those on the approved bid list are called to a meeting with the FDIC regional director They are given the bid package, a draft of the sale agreement, and instructions on the regulatory approvals needed, capital requirements that must be maintained after acquisition, and the rules of the bidding process Bidders are permitted to ask any clarifying questions, but only in the presence of all the other bidders so all have the same information

Sealed bids are due at the regional office at the hour of the anticipated closing. After the bids are opened, the top bid is checked to see if it meets the minimum dollar figure, conforms in every respect to the guidelines, and if all necessary regulatory approvals have been received If all is in order, the board can approve the sale in a matter of minutes The regional director phones in with the bid information; the FDIC board convenes in a special meeting and promptly acts

Those are the easy ones When there are no bidders, or no qualified bidders, or if the offer is too low to comply with the cost test, FDIC scrambles to decide what to do.

One approach is to ask the high bidder to increase the bid. If the high bidder declines, he then is asked if he is interested in a *deposit transfer*, that is, a payoff of insured deposits using the bidding bank as agent. If he again declines FDIC goes to the last resort—straight FDIC payoff.

Complications arise and board participation intensifies in the unusual cases The bailout candidates, for example. Or when a payoff is indicated for a very large bank. Or when another bank has a big stock investment in the failing institution and wants to negotiate to take it over without competitive bidding. Other instances requiring concentrated attention and innovative decisions include Working out solutions to the problems of giant mutual savings banks. Deciding what to do when multiple failures in a state have made the qualified bid list too small to be meaningful. Determining how to handle large failures when the sale process will not work because of anticompetitive problems or lack of a large enough suitor Resolving what to do about chain and related banks, such as the Butcher banks in Tennessee or the Parsons chain in Michigan The special cases seem to grow

The pendulum has swung once again toward 100 percent protection of depositors and creditors. Despite the fact that Congress made it clear in the 1950 Act that FDIC was not created to insure all deposits in all banks, in the years since Congress has gradually increased the insured amount to $100,000 In addition, the regulators have devised solutions that protect even the uninsured in the preponderance of cases. The exceptions, where no such solution can be devised, produce the unfairness factor

Now you know the law, who the regulators are, and the ground rules under which they operate Next How is the law implemented?

PART TWO

The First Three Bailouts

another that owed $34 million, and two other borrowers that owed $140 million between them went to court in a futile attempt to prevent Continental from transferring their loans to FDIC. They would prefer Continental over FDIC as their creditor—nervy, coming from people whose debts were a part of the Continental problem

The FDIC Liquidation System

What Continental does for FDIC under contract in Chicago is just one station of a far-flung liquidation empire It gets bigger every time another bank fails. With the single exception of Continental, this empire is staffed and operated by our own employees As in Chicago, their job is to collect money owed to banks that failed, those debts turned over to FDIC That activity, rarely pleasant, has produced rude awakenings for increasing numbers of delinquents who find their loans in the hands of FDIC These borrowers—including energy speculators, near-bankrupt farmers, and others—view FDIC far differently from its traditional image as the good guy protector of deposits To them FDIC is the debt collector in the black hat Yet it is a necessary function and a fascinating one as well

FDIC's liquidation operation is best described as something akin to the duties of a mortician When a bank dies, FDIC tidies up the remains and disposes of them

The deposit insurance cycle begins when a bank is closed and FDIC is appointed receiver. The first task to is take custody of the bank A team of liquidation personnel, gathered from throughout the nation, assembles in the vicinity of the bank the night before the closing This is done in great secrecy since a hint that FDIC is mustering could start a run Those who got

the word and took their money out would have an unfair advantage over other depositors.

Once the bank is closed, the FDIC team works around the clock, usually over a weekend, to prepare for either a payoff of depositors or sale of the bank, depending on what the board decided In either instance, the insured depositors have access to their money in short order, usually the next banking day.

In many instances, the initial task is formidable New York City's Franklin National Bank, which failed in 1974, operated 108 branch offices, its closing required a force of 778 FDIC personnel, most of whom were examiners from around the nation on temporary assignment. For the unexpected closing of the First National Bank of Humboldt, Iowa, in 1982, FDIC people battled tornadoes and then a snowstorm to get to the bank. Trips that should have taken a few hours turned into two-day ordeals with some employees finally arriving after hitchhiking on tractor trailers or being transported in state police cars

The weekend of the Humboldt travails, we also arranged mergers for a failing $2 billion savings bank in Philadelphia and a small Virginia bank for which no buyer could be found until nearly midnight Sunday It is not unusual for FDIC's board to meet late at night on Fridays, Saturdays, or Sundays to handle a failed bank

In the early days—the 1930s—failed banks were very small. In 1940 even after seven years of averaging fifty failures a year, the assets acquired by FDIC for liquidation stood at just $136 million. Then FDIC's liquidation function was easily handled

For the next thirty years, as the failures dwindled, so did FDIC's liquidation workload. The asset inventory did not again reach the 1940 level until 1971 In the 1970s and 1980s, both the number and the size of failed banks increased dramatically. The Penn Square failure in 1982 alone left FDIC with a tangle of loans that will take years to resolve. In 1983 the $1 4-billion

First National Bank of Midland, Texas, and the series of Butcher bank failures in Tennessee brought the book value of FDIC's bad assets to the then unheard of total of $5 billion Then came Continental, driving the inventory beyond the $10-billion mark, reflecting more than 142,000 different assets Besides Continental, there were 338 other active liquidations of failed banks at year-end 1985 In its over fifty-year history FDIC handled and concluded 537 other liquidations

The accelerating pace of bank failures spurred the corporation to find new, more efficient ways to handle the job before the task got out of hand One tack was to be more restrictive about the assets retained. In a payoff where there is no purchaser of the bank, FDIC must receive and liquidate all assets In a closed-bank sale, FDIC can be more choosy and take only the lousiest assets FDIC's job is to absorb the loss after wringing whatever recovery it can out of assets that made a bank go broke. There is no point in dumping somebody else's bad loans into a good bank and creating a new problem. The same old assets would wind up in FDIC's lap again, anyway. So FDIC is being more aggressive in passing the best of a failed bank's assets to an acquiring bank That leaves the corporation free to concentrate on the worst assets. For many years, the purchasing bank acquired only the bank premises and the good installment loans; it had a sixty-day option to purchase any of the remaining assets In 1985 FDIC began passing good-quality commercial and mortgage loans to the acquiring bank and allowing that bank a period in which to send the lemons back.

Part of FDIC's new effort was simply to hire more staff By year-end 1985, our liquidation force of 3,300 represented nearly half of the total FDIC employment of 7,125 The liquidation staff has increased tenfold since 1981 when we had fewer than one hundred active liquidations, most of them small. During the 1940s when FDIC was handling some 400 open liquidations, the staff numbered about 1,600. By 1950 after FDIC had liquidated much of that backlog, the entire Division of Liquidation had only thirty-two full-time positions, including secretarial and support workers.

Another major innovation has been the consolidation of work sites into larger production-type operations During the sleepy years each liquidation was handled individually. A liquidator was named, moved to the site, and stayed until the assets were disposed of or until he or she was called to a new closed bank In the 1980s FDIC opened regional offices in Atlanta, Dallas, Kansas City, Chicago, New York, and San Francisco, with subregional offices in 23 areas of the heaviest bank failure activity

Under this new procedure, the liquidation still begins at the site of the closed bank, but the assets are quickly pulled into a subregional or regional office where they are segregated by category and worked by specialists. This approach makes possible economies of scale and the mustering of legal and marketing expertise

FDIC's liquidation activities are not a fire sale or forced liquidation in any sense of the word. The law requires FDIC to get the maximum possible recovery out of an asset, no matter how poor it may be So the staff is prepared to negotiate a sale, solicit bids, hold an auction or do whatever else it may take to dispose of an asset, or to wait to get a better price if that is in FDIC's best interests Further, FDIC works loans—that is, prods borrowers into making their payments according to terms of the loan and may renegotiate loans to give the borrower some time in return for a higher interest rate or a better ultimate return to FDIC. If an asset is an ongoing business—a motel or restaurant, for example—FDIC is prepared to keep it operating to preserve its value until the corporation can market it advantageously What FDIC cannot do is throw good money after bad, advancing more funds to a borrower with no prospect for repayment.

Besides maximizing the agency's return as its statutory fiduciary responsibility requires, this businesslike approach also minimizes the impact on a community FDIC does not depress a local market by dumping assets indiscriminately within a short time after the bank's closing In fact, the FDI Act requires liquidations to be conducted "having due regard to the condition of credit in the locality"

The immense volume of bad loans FDIC acquired from Continental and scores of other failed banks and the collapse of the Midwest farm economy in 1984 and 1985 put this policy to the test Suits by and against borrowers mushroomed. In their desperation and distress, farmers asked FDIC to forgive their loans, make new loans, extend old loans, or allow some other indulgence. FDIC's policy has been forbearance to the extent the law allows.

As collections accumulate in a liquidation, FDIC periodically declares dividends which are paid pro rata to all uninsured depositors and creditors, including itself in lieu of insured depositors. In a few rare cases, creditors may ultimately be paid in full, including interest More likely, however, creditors will receive 80 to 85 percent of their claims If anything should be left after all claims and liquidation expenses are paid, it goes to shareholders Receiverships of failed banks, like any receivership, are conducted under the jurisdiction of the courts, and sales of assets by the receiver are subject to approval by the courts.

Liquidations may take years; recent large failures may require ten years or more to complete. The Public Bank in Detroit and San Francisco National Bank liquidations have endured almost two decades and they were still on the books when we established reserve for losses in early 1986 Liquidation of Franklin National Bank in New York and U S National Bank in San Diego continues after more than a dozen years apiece The speed of liquidation depends largely on the number and size of acquired assets and their salability.

Among the unusual assets bequeathed FDIC by failed banks was *And They're Off,* a partially completed motion picture about

the horse racing industry starring Tab Hunter and Jose Ferrer. The exotic assets the corporation has acquired over the year are legion One I was particularly fascinated with as a history buff was General Custer's knife and a shirt from one of Sitting Bull's warriors adorned with scores of scalps.

After FDIC acquired a large almond orchard near Bakersfield, California, in the U.S National Bank failure in 1973, squirrels ate 25 percent of the crop Then almond prices fell by half, so operations were abandoned and FDIC sold the property at fire sale prices Even this did not work The buyer returned the land and it had to be sold again. The process was repeated in 1985 as we reacquired the property through foreclosure Some assets seem to be destined to stay in our inventory in perpetuity

In 1978 the corporation took over a loan collateralized by a Chicago warehouse filled with a million pounds of meat After the refrigeration broke, the rats took over. The liquidators drew the line at becoming exterminators Actually, FDIC had little say since it was not the proprietor of the warehouse, merely a creditor. Needless to say, our chances of collecting on a mortgage of several hundred thousand dollars went as bad as the meat

FDIC also has had interests in oil tankers, shrimp boats, and tuna boats and has experienced many of the pitfalls facing the maritime industry An oil tanker ran aground, a shrimp boat was blown by a hurricane onto the main street of Aransas Pass, Texas; and tuna boats were idled when the price of tuna dropped sharply. Other liquidation assets have included several taxicab fleets, countless idled oil drilling rigs, distribution rights to an X-rated movie, a coal mine that was on fire the day the bank was closed, a horse training facility with two inept race horses and quarter horses greatly overvalued at several million dollars, thousands of art objects including an antique copy of the Koran, a collection of stuffed wild animals, and all types of real estate including churches and synagogues FDIC has taken over as many as 400 single-family mortgages and as much as $500 million in international loans from single bank failures