



United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-257964

August 26, 1994

Mr. Andrew C. Hove, Jr.
Acting Chairman
Federal Deposit Insurance Corporation

Dear Mr. Chairman:

In our recent review of the Federal Deposit Insurance Corporation's (FDIC) resolution of CrossLand Federal Savings Bank of Brooklyn, New York, we reported¹ that FDIC made an equity investment in the institution to facilitate its resolution. Since 1984, FDIC has used equity investments to facilitate the resolution of failing banks. Equity investments can provide a means for FDIC to reduce insurance fund costs and even share in any future profit. However, such investments can also lose money and thereby increase the size of insurance fund costs. Because equity investments can change FDIC's role after the resolution from that of an insurer and regulator of banks to also being an investor, investment strategies need to be carefully structured and implemented. Otherwise, they could create the perception of a bias on FDIC's part, in favor of a bank in which FDIC takes an equity interest, and weaken its credibility as a bank insurer and regulator.

We are concerned about the policy implications of FDIC taking equity positions in institutions for which it has oversight and insurance responsibilities as well as how FDIC manages and disposes of such equity investments. As a result of our inquiry into FDIC's making, managing, and disposing of such equity investments, we found that FDIC policies do not fully consider the policy implications of making equity investments in resolution transactions to ensure that such a practice best serves its interest as a deposit insurer. Specifically, we found that FDIC does not have formal policies that describe the circumstances under which such an investment would be considered, nor does it have formal policies for managing, and disposing of the equity investments it has made.

¹Failed Banks: FDIC Sale of CrossLand Conservatorship Satisfied Least-Cost Test, (GAO/GGD-94-109, Apr. 20, 1994).

BACKGROUND

As a part of the August 1993 final resolution of CrossLand, FDIC took warrants to purchase 1 million shares of CrossLand common stock, or approximately 7.2 percent of its fully diluted outstanding common stock. In our report² on the final resolution, we did not identify problems in the way the Division of Resolutions (DOR) acquired or valued these CrossLand warrants.

FDIC has reported that it has made equity investments in 19 assistance transactions totaling \$4.2 billion since 1984. Its investments in Continental Illinois National Bank and First City Bancorporation accounted for approximately \$2 billion or 50 percent of the total equity investments. According to FDIC officials, from 1984 to 1991 FDIC generally used equity investments as a vehicle for providing assistance in bank resolutions to facilitate the best FDIC resolution alternative. FDIC considered any losses from these investments to be a cost of the resolution.

In 1991, FDIC implemented a shared-equity program to provide for interim equity financing to facilitate acquisitions by acquirers of failed institutions. DOR officials advised us that this program requires FDIC generally to agree to consider an investment only if FDIC's investment constitutes 50 percent or less of the capital believed needed to adequately recapitalize a troubled bank. The officials added that FDIC, in its program, encourages early redemption of any equity investment that it makes. FDIC officials told us that seven shared equity investments were made by FDIC from 1991 through 1992 and that each of these investments has been paid back in full.

In FDIC's equity investment in CrossLand in 1993, FDIC accepted warrants as part of the purchase price in the sale of CrossLand, which FDIC owned and was operating through a conservatorship. These securities were then valued as part of the purchase price by the acquirer and, according to the CrossLand prospectus, they are to remain available for sale by FDIC in the marketplace until August 2003.

POLICY IMPLICATIONS ASSOCIATED WITH EQUITY INVESTMENTS

FDIC's regulator and insurance roles are to protect depositors in the nation's banks, help maintain confidence in the banking system, and promote safe and sound banking practices. FDIC's credibility in these roles is based on promoting fairness, efficiency, and confidence in the banking system. We believe

²Ibid.

that the FDIC practice of making equity investments in resolution transactions has important policy implications. While such investments can allow FDIC to gain from successfully resolving troubled banks, they can also change FDIC incentives and potentially create, at least, the appearance of being less than independent and objective in its dealings with troubled banks. Specifically, problems for FDIC could potentially manifest themselves in issues such as (1) the appearance of favoritism shown by FDIC toward an institution in which FDIC holds an equity interest, (2) control weaknesses over the dissemination of inside information about FDIC's intentions regarding its investments, and (3) consistency in valuing equity holdings in accordance with the least-cost provisions of the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

We believe that without specific FDIC policies about making, managing, and disposing of equity investments, a competitor bank in the acquisition of a troubled bank could assert that an unfair advantage was being given to an institution in which FDIC holds an equity investment. For example, if FDIC holds equity in a particular bank, a competitor bank could question FDIC's independence as an insurer and regulator within the banking community.

We also believe that control weaknesses over the dissemination of inside information about FDIC's intentions for making, managing, and disposing of equity investments could potentially erode FDIC's credibility as an insurer and regulator. Currently, FDIC does not have formal policies to control access to sensitive information regarding FDIC investment strategies. Management responsibility for FDIC equity investments is currently designated to a single DOR official--whose responsibilities for the equity investment portfolio are separated from those related to the DOR resolution decisionmaking processes. However, without formal policies to ensure the separation of these duties and to restrict the dissemination of information, FDIC could appear to be using sensitive information to its own advantage. For example, if FDIC were to exercise warrants or dispose of another type of equity investment that it held in a particular institution while resolving another troubled institution in the same geographic area, FDIC may appear to have, at least in part, based its trading decision on information that was not generally available to the public.

Further, the FDIC practice of taking an equity position as part of a resolution transaction could complicate FDIC's calculations under the least-cost provisions of FDICIA. For example, if an institution in which FDIC has an equity position were to acquire a failed or failing bank, such an acquisition would likely affect the value of that equity position. As a result, to calculate the least-cost resolution alternative, FDIC would have to estimate the change in value for each equity in its portfolio--whose value

depends on the resolution decision--and incorporate the results in calculating the net cost of the bid. FDIC would then have to compare these results against other resolution alternatives to make a least-cost determination. Changes in the value of equity investments held by FDIC can change the cost of a resolution as well as affect the resolution alternative that is chosen.³

Currently, FDIC does not have specific guidance to inform it when to make equity investments that would be in its best interest. Once they are made, equity investments become part of the equity investment portfolio to be managed by a DOR official. The valuation and accounting treatment of the portfolio is to be coordinated between DOR and the Division of Finance. Any disposal strategy is to be considered when DOR submits a recommendation to the FDIC Board of Directors for approval. These activities are currently performed without the benefit of formal procedures to ensure adequate control over the activities.

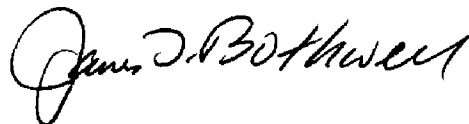
We discussed a draft of this letter with the Director of DOR and other DOR officials who said they recognized the need to have formal policies and procedures for making, managing, and disposing of equity investments. However, they said that they do not consider the lack of formal procedures to be of urgent or major importance. They said that since they do not anticipate a major influx of resolutions in the near future, and anticipate that making additional equity investments are even less likely, the task of drafting policies and procedures has not been considered a high priority. While we understand the validity of this reasoning, we also note that the current low volume of resolutions provides FDIC a good opportunity to (1) assess its practices for making equity investments in resolution transactions and (2) review its policies and procedures relative to equity investments already taken to ensure they adequately protect FDIC's interests and credibility.

To review FDIC's handling of its equity investment portfolio, we reviewed documents on FDIC's equity investments made since 1984 and interviewed officials from FDIC's DOR, Division of Depositor and Asset Services, and the Division of Finance in the Washington D.C. area. We did our work from March 1994 through June 1994 in accordance with generally accepted government auditing standards.

³In the only case we examined, this issue did not arise because the bids involved separate insurance funds.

Our work was done under the direction of Mark Gillen, Assistant Director, Financial Institutions and Markets Issues. If you have any questions concerning this letter please contact me on (202) 512-8678 or Mr. Mark J. Gillen on (202) 942-3810.

Sincerely yours,

A handwritten signature in cursive script that reads "James L. Bothwell". The signature is written in dark ink and is positioned above the typed name.

James L. Bothwell
Director, Financial Institutions
and Markets Issues