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- Failure Resolution and Asset Liquidation
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- Recent Developments

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The author summarizes and discusses results of a Federal Deposit Insurance Corporation survey of foreign deposit insurance organizations. The article focuses on procedures for resolving and liquidating failed banks.

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This regular feature of the *FDIC Banking Review* contains information on regulatory agency actions, state legislation and regulation, and articles and studies pertinent to banking and deposit insurance issues.

Editor's note: In "The Cost of the Savings and Loan Crisis: Truth and Consequences," which appeared in the last issue of the FDIC Banking Review, footnote 2 referenced an American Banker commentary by Kenneth H. Thomas in which he wrote "The public did not realize the monster Congress had created until taxpayers got the roughly $500 billion bill for bailing out the thrift industry." Subsequent to publication, Mr. Thomas informed us the $500 billion figure was a typographical error and that he meant to write $150 billion, a figure he had used in previous articles and more in concert with the cost of the S&L crisis calculated in this article.

Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers

by Rosalind L. Bennett*

A large part of any country's financial safety net[1] is the winding up, or resolution and asset liquidation, of insolvent banks.[2] Even in a healthy economy, banks may become troubled. When a bank is no longer a viable business, the financial safety net should provide for that bank's resolution and asset liquidation. And often a majority of the claims on a failing bank are the deposits, which the deposit insurer is responsible for reimbursing. Thus, the deposit insurer plays a role in the resolution of insolvent banks.

In January 2000, the Federal Deposit Insurance Corporation (FDIC) sent a survey on deposit insurance practices to 73 foreign deposit insurance organizations. These 73 insurance organizations represent all explicit deposit guarantee programs in existence at the beginning of the year 2000 (excluding those in the United States). The survey's questions address the characteristics of deposit insurance systems by focusing on five general areas: (1) risk assessment, (2) funds availability, (3) failure-resolution methods, (4) the role of the receiver, and (5) asset liquidation.

As of June 2000, 37 deposit insurers in 34 locations had completed and returned the survey.[3] The locations of the respondents can be categorized as "advanced economies," "developing economies," or "economies in transition."[4] At year-end 1999, these 34 economies—which account for over one-half of world gross domestic product (GDP)—contained 6,000 banks and over 65 percent of the banking assets in the world. (See Table 1.)

This article reports on the nature and extent of the role played by the 37 survey respondents in winding up failed banks. The article summarizes and discusses only the results of questions that directly address the resolving and liquidating of failed banks.[5] The article does not discuss relationships between the resolving and liquidating of failed banks and other topics in the survey (the supervision of banks, the funding of the deposit insurance scheme, and the transparency of financial reporting).[6]

The article draws upon both the academic literature and the practical experience of the United States with deposit insurance systems. The lessons the FDIC has learned may help other countries design effective policies related to the winding up, or the resolution and asset liquidation, of failed banks. The position of this

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[1] For the purposes of this article, the safety net refers to the deposit insurance system, the resolution of failed banks, and the liquidation of failed-bank assets.

[2] For simplicity, in this article the term "bank" refers to any deposit-taking financial institution.

[3] Some locations have more than one deposit insurer. Not every question was answered by each respondent so there may be less than 37 responses to each question.

[4] The classification of economies into "advanced," "developing," or "in transition" is from International Monetary Fund (2000). In the tables, the second and third categories are combined into one.

[5] Articles summarizing and discussing the risk assessment and funds availability portions of the survey will appear in future issues of the *FDIC Banking Review*.

[6] One example of these kinds of connections: how the appropriate authority will resolve a failed bank is affected by the funding of the deposit insurance scheme.

Table 1
Survey Respondents, Summary Statistics, 1999

Deposit Insurer	Population: Total Population (millions)	Population: Share of World Population (percent)	GDP: Total GDP (US$ millions)	GDP: Share of World GDP (percent)	Banking Industry: Number of Banks	Banking Industry: Banking Assets (US$ billions)	Banking Industry: Share of World Banking Assets (percent)
Advanced Economies							
Austria	8.18	0.14%	$ 208,949	0.69%	844	$ 608.3	1.32%
Belgium	10.15	0.17	245,706	0.81	84	938.1	2.03
Canada	30.49	0.52	612,049	2.03	112	584.6	1.27
France	59.10	1.01	1,410,262	4.67	328	3,506.3	7.59
Germany	82.09	1.40	2,081,202	6.89	2,517	6,877.7	14.89
Greece	10.63	0.18	123,934	0.41	28	82.1	0.18
Isle of Man[a]	0.08	0.00	985	0.00	49	n.a.	n.a.
Italy	57.34	0.98	1,149,958	3.81	363	2,263.2	4.90
Japan	126.51	2.15	4,395,083	14.55	177	7,620.0	16.50
Netherlands	15.81	0.27	384,766	1.27	80	1,328.5	2.88
Portugal	9.96	0.17	107,716	0.36	50	334.2	0.72
Spain	39.42	0.67	562,245	1.86	154	1,470.1	3.18
Sweden	8.86	0.15	226,338	0.75	40	260.1	0.56
Taiwan Province of China	22.00	0.37	362,000	1.20	49	n.a.	n.a.
United Kingdom	58.74	1.00	1,373,612	4.55	302	3,628.3	7.86
Subtotal	**539.36**	**9.18%**	**$13,244,805**	**43.85%**	**5,177**	**>$29,501.5**	**>63.88%**
Developing Economies and Economies in Transition							
Africa							
Nigeria	108.95	1.85	43,286	0.14	81	9.5	0.02
Tanzania	32.79	0.56	8,777	0.03	10	1.3	0.00
Uganda	21.62	0.37	6,349	0.02	21	0.9	0.00
Europe							
Czech Republic	10.28	0.17	56,379	0.19	36	84.5	0.18
Hungary	10.07	0.17	48,355	0.16	46	26.7	0.06
Latvia	2.43	0.04	6,664	0.02	25	3.2	0.01
Lithuania	3.66	0.06	10,454	0.03	11	2.7	0.01
Poland	38.65	0.66	154,146	0.51	87	76.2	0.17
Romania	22.46	0.38	33,750	0.11	18	8.0	0.02
Slovak Republic	5.40	0.09	19,307	0.06	25	15.6	0.03
Turkey	64.39	1.10	188,374	0.62	67	96.2	0.21
Middle East							
Bahrain	0.67	0.01	5,350	0.02	36	8.1	0.02
Oman	2.46	0.04	14,962	0.05	18	9.4	0.02
Western Hemisphere							
Brazil	163.95	2.79	760,345	2.52	208	286.5	0.62
El Salvador	6.15	0.10	12,229	0.04	18	7.6	0.02
Jamaica	2.56	0.04	6,134	0.02	16	4.1	0.01
Mexico	97.37	1.66	474,951	1.57	63	202.7	0.44
Peru	25.23	0.43	57,318	0.19	20	20.4	0.04
Trinidad and Tobago	1.29	0.02	6,998	0.02	17	3.7	0.01
Subtotal	**620.38**	**10.54%**	**$ 1,914,128**	**6.34%**	**823**	**$ 867.3**	**1.88%**
Total	**1,159.74**	**19.72**	**15,158,933**	**50.18**	**6,000**	**>30,368.8**	**>65.77**
United States	**273.13**	**4.65**	**8,708,870**	**28.83**	**8,907**	**7,956.9**	**17.23**
World	**5,879.00**	**100.00%**	**$30,211,993**	**100.00%**	**n.a.**	**$46,177.5**	**100.00%**

Note:

Population—1999 midyear estimates. *Source:* International Monetary Fund (June 2000), *International Financial Statistics*. Taiwan Province of China and Isle of Man statistics from CIA (1999), *World Factbook*.

GDP—1999. *Source:* World Bank, 2000, Development Indicators. Taiwan Province of China and Isle of Man statistics are 1998 estimates from CIA (1999), *World Factbook*.

Banking Industry—Number of banks. *Source:* Thomson Bank Directory (2000), Thomson Financial Publishing. Banking assets as of 1999: International Monetary Fund (June 2000), *International Financial Statistics* (bank assets are summations of lines 20 through 22 in the International Financial Statistics, converted to December 1999 U.S. dollars). World total does not include Afghanistan, Dem. Rep. of Congo, People's Dem. Rep. of Yemen, St. Pierre & Miquelon, and Vietnam. December 1999 data were not available for Djibouti, Greece, Guinea, Republic of Yemen, so data from second-quarter 1998 were used.

[a]British Crown Dependency.

article, however, is that there are no universal best practices or one-size-fits-all policy prescriptions. Among other considerations, differences in the level of transparency of financial reporting, in the effectiveness of supervision, in legal structures, and in the accountability of public officials will determine which design features of the safety net will best fit any one country.

Conceptual Background

A financial safety net has three principal goals: (1) to maintain stability and public confidence in the financial system, (2) to minimize the cost of resolving failed banks but without weakening the financial system, and (3) to have the receiver dispose of the remaining assets as soon as practicable.

When dealing with failed or failing banks, the challenge in achieving the first goal is to do it with the least possible interference with market mechanisms. Resolving failed banks in a manner that undermines market discipline (for example, by covering all deposit and creditor claims) will simply weaken the financial system in the long run by encouraging excessive risk taking. But not resolving failed banks promptly will also undermine the market mechanism—and may, in addition, substantially increase the costs of a resolution.

Accordingly, the financial safety net includes policies on failure resolution, and it is advantageous to make the policies clear to the public. Transparency in the rules governing the resolution of failed banks helps to produce order in the financial system. Clear, specific, and publicly known regulatory policies provide banks and their customers with more information on which to base their decisions. And when depositors and other bank creditors know which claims the deposit insurer will honor quickly, they are unlikely to generate liquidity crises in well-run banks. In other words, policies that reduce the uncertainty of claimants about the amounts they will recover, especially when these policies are accompanied by prompt payment of claims, increase public confidence in the financial system. Unclear regulatory policies—along with poor bankruptcy or receivership laws and the lack of timely failure resolutions—can contribute to and exacerbate financial crises.

The challenge posed by the second goal of any financial safety net (to minimize the cost of a failure resolution without weakening the financial system) lies in the fact that minimizing disruption to the economy and maintaining public confidence in the financial system can be costly. One way of meeting this challenge is to adhere to a least-cost requirement; that is, to evaluate the cost of different failure-resolution techniques and determine which is the least costly to the deposit insurer. If a strict least-cost requirement is in place, regulators are not allowed to weigh secondary damage to the community or to other banks when determining which resolution transaction to use.

The third goal of the safety net applies to those resolution techniques that require some or all assets to remain with the receiver and calls for the receiver to dispose of the remaining assets as soon as is practicable. This goal is consistent with the other two goals. When assets held by the receiver are not returned to the private markets as soon as is practicable, the economy may be disrupted. Inversely, returning assets quickly to the private sector minimizes disruption to the local economy by allowing for quicker payments to the remaining creditors of the failed bank, thereby meeting goal one. In addition, liquidating assets quickly accomplishes goal two by eliminating costs associated with holding the assets, such as servicing costs.

Practice in the United States

In the United States, winding up the affairs of a bank that has failed typically involves two stages. The first stage—the resolution stage—is the process of resolving a failed bank; the second stage is the process of liquidating the assets of the failed bank (the receivership process). The receivership process is used for all resolutions except open-bank assistance.

In the resolution stage of most transactions the FDIC values the assets of the failed bank, solicits bids for the sale of the bank, and evaluates the bids to determine which one is the least costly to the insurance fund.[7] If the least costly bid involves the acquisition by a bank of some or all of the assets and liabilities of the failed bank, the FDIC works with the acquiring bank until the end of the closing process. If the least costly bid does not involve an acquirer, the FDIC ensures timely payment to insured depositors and liquidates the assets over time.

[7] Typically, the FDIC places similar assets in pools and allows bidders to bid on the asset pools. Bidders have the option to bid on some or all of the asset pools and on some or all of the deposits of the failed bank.

During the second stage—the receivership process[8]—the FDIC liquidates any remaining assets of the failed bank and distributes the proceeds, first to the uninsured depositors, then to the general creditors, and finally to the shareholders.[9]

When and How a Bank is Closed and Resolved

Before the winding-up process, the bank must first be closed. This section discusses three issues surrounding bank closure: the rules for closure, the timing of closure, and who has the authority to close banks. After the bank is closed, and before the winding-up process can begin, a receiver must be appointed for the failed bank. This section also discusses many aspects of the appointment of a receiver, such as who appoints the receiver and who usually acts as the receiver. The last part of the section discusses the differences between the receivership process for a failed bank, as conducted in the United States, and the corporate bankruptcy process.

Bank Closure Rules

Banks are typically closed for one of two reasons: insolvency or illiquidity. Insolvency occurs when the value of the assets held by a bank is less than the value of the liabilities held. Illiquidity occurs when a bank is not able to meet its current obligations as they come due.

Insolvency can be measured by either book value or market value. Accounting conventions usually require that banks report assets and liabilities at book value, and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires regulatory agencies in the United States to close banks before they reach book-value insolvency.[10] The reason for this closing rule is that the market value of the assets of a bank is uncertain and in troubled banks is typically below the book value. Closing a bank before it reaches book-value insolvency allows for this uncertainty and helps limit the losses incurred by the deposit insurance funds.

Illiquidity may arise because banks issue demand deposits—obligations due upon demand—to fund lending activity, and are therefore susceptible to bank runs. When depositors know or believe that a bank is in danger of failing, they may attempt to withdraw their deposits as quickly as possible, causing a liquidity crisis at the bank.

A bank can be illiquid without being insolvent. In the United States, primarily because of deposit insurance and the central bank's ability to provide liquidity, banks usually fail because they are insolvent rather than because they are illiquid. In most of the cases when a U.S. bank was closed for illiquidity, the liquidity problem had been caused by a belief that the bank was insolvent, even though the insolvency had not yet been realized in the accounting statements.

In contrast, the European Union (EU) directive on deposit-guarantee schemes (94/19/EEC) is concerned with illiquid—not necessarily insolvent—banks. The directive requires the activation of the deposit-guarantee scheme when deposits become unavailable. Although the EU also has adopted directives 89/647/EEC and 89/299/EEC that outline capital standards consistent with the Basel capital standards, no EU directive currently requires the closure of an insolvent bank.[11]

The responses to the survey of deposit insurers indicate that in practice a majority of respondents close banks when they become insolvent. Of the 37 deposit insurers that had responded as of June 2000, over two-thirds answered "Yes" to the following survey question: *Are troubled insured depository institutions routinely closed and liquidated or otherwise reorganized when equity capital is exhausted?* This proportion was roughly similar for both groups of deposit insurers, those in advanced economies and those in developing economies and economies in transition. (See Table 2.)

Timing of Bank Closure

When the resolution of a failed bank is performed quickly and smoothly, benefits accrue to the economy and to the financial system. The swift resolution of a small bank minimizes disruption to the local community. The swift resolution of a large bank is especially critical because the failure of the bank may affect the national economy.

[8] The receivership process is similar to the bankruptcy process used in countries other than the United States. However, as discussed later in the article, the receivership process differs from the bankruptcy process in important ways.

[9] In the resolution stage, the FDIC provides timely payment to the insured depositors; then, during the receivership process, the FDIC stands in the place of the insured depositors. Claimants on the receivership (including the FDIC itself, as the receiver that has administrative expenses and as the stand-in for the insured depositors) receive payment according to their assigned priority, as dictated by the Omnibus Budget Reconciliation Act of 1993; the relevant provisions are commonly known as National Depositor Preference. The priority is as follows: administrative expenses of the receiver, secured claims, domestic deposits (insured and uninsured), foreign deposits and other general creditor claims, subordinated creditor claims, and shareholders. For more detail on National Depositor Preference, see Marino and Bennett (1999).

[10] The prompt corrective action provisions of FDICIA require the regulatory agency to close a bank that has a ratio of tangible equity to assets that is less than or equal to 2 percent.

[11] For more information on financial developments in the EU, see Murphy (2000).

Table 2
Bank Closures

Deposit Insurer	Are troubled depository institutions routinely closed and liquidated or otherwise reorganized when equity capital is exhausted?		Have there been examples where equity-insolvent, insured depository institutions have been allowed to operate for extended periods?	
	Yes	No	Yes	No
Advanced Economies				
Austria (AAR)		X		X
Austria (AABB)		X		X
Belgium		X		X
Canada	X		X	
France	X			
Germany (EdB)	X			X
Germany (E)	X			X
Greece	X			X
Isle of Man[a]		X		X
Italy (IDPF)	X			X
Italy (DPFCB)	X			X
Japan	X		X	
Netherlands		X		X
Portugal		X		
Spain	X			X
Sweden	X			
Taiwan Province of China		X	X	
United Kingdom	X			
Subtotal	**11**	**7**	**3**	**11**
Developing Economies and Economies in Transition				
Africa				
Nigeria	X		X	
Tanzania	X		X	
Uganda	X		X	
Europe				
Czech Republic	X			X
Hungary	X			
Latvia		X		
Lithuania	X		X	
Poland		X		X
Romania	X			X
Slovak Republic	X			X
Turkey	X			
Middle East				
Bahrain	X			X
Oman		X		X
Western Hemisphere				
Brazil		X		
El Salvador	X		X	
Jamaica	X		X	
Mexico		X		
Peru	X			X
Trinidad and Tobago	X		X	
Subtotal	**14**	**5**	**7**	**7**
Total	**25**	**12**	**10**	**18**

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

[a]British Crown Dependency.

AAR = Association of Austrian Raiffesenbanks

AABB = Association of Austrian Banks and Bankers

EdB = Entschadigungseinrichtung deutscher Banken

E = Einlagensicherungs

IDPF = Interbank Deposit Protection Fund

DPFCB = Deposit Protection Fund for Co-operative Banks

Banks typically fail after a gradual deterioration rather than after a single adverse event. Thus, the timing of the closure of a bank directly affects the costs to the deposit insurer: generally the longer the condition of a bank deteriorates, the higher the resolution cost to the deposit insurer. As a bank approaches failure, uninsured, unsecured liabilities will either flee or attempt to become insured or secured.[12] In addition, managers of the bank will have an incentive to take on more risk in an attempt to earn sufficient returns to save the bank from failure. Usually, however, these actions result not in high returns to the bank but in higher losses to the deposit insurer.

In the United States, FDICIA contains prompt corrective action provisions that formalize the timing of regulatory actions and closure on the basis of capital ratios. As the capital of a bank deteriorates, prompt corrective action requires bank regulators to initiate progressively more-stringent restrictions on the activities of the bank. Thus, prompt corrective action requires the bank regulators to intervene early; and, by formalizing the process, prompt corrective action significantly reduces the potential for regulators to apply forbearance.[13] Formalizing early intervention may also limit excessive risk taking by making bank managers aware of the consequences of their actions.[14]

Outside the United States, formal early-intervention rules are not widespread, but in practice most survey respondents generally do intervene when a bank is insolvent. Eighteen of the 28 respondents replied "No" to the following survey question: *Have there been examples where equity-insolvent, insured depository institutions have been allowed to operate for extended periods?* (See Table 2.) An insolvent bank is more likely to continue to operate in developing economies or economies in transition: one-half of the respondents in this group (7 of 14) have allowed insolvent banks to operate, whereas only 3 of the 14 deposit insurers in advanced economies have done so.

Authority to Close a Bank

How long an insolvent bank is allowed to linger may be influenced by who has the authority to close a bank. Insolvent banks may be more likely to linger if the authority to close a bank does not lie with the entity that is accountable for the costs of forbearance. The costs of forbearance are borne by the creditors of the impending receivership—including the deposit insurer (as explained in note 9). In a government-sponsored deposit insurance system, the ultimate cost of forbearance may be borne by the taxpayer.

In the United States, the entity that charters the bank has the authority to revoke the charter—essentially, to close the bank.[15] After closing the insured bank, the chartering agency usually appoints the FDIC as receiver (see next subsection). Alternatively, in some circumstances the FDIC itself has the authority to close a bank, or terminate deposit insurance.[16]

Thirty-seven survey respondents answered the following question: *Who can declare a commercial bank legally insolvent?* Thirty-five of the 37 specified that a government agency (including the court system) has the authority to declare a bank insolvent. In the remaining two economies (Canada and Bahrain), a government agency can declare a bank insolvent or a private party—specifically the creditors of the bank—can petition the court for a winding-up order.

Appointment of a Receiver

Once the authorized entity closes a bank, usually the bank requires a receiver. The duties of a receiver for a bank are to market its assets, sell them, and distribute the proceeds, after expenses, to the creditors of the bank. As mentioned in the previous subsection, in the United States the chartering authority closes the bank and appoints the FDIC as receiver. Thus, the FDIC acts as both the deposit insurer and the receiver of failed banks. Having one agency discharge both these functions simplifies procedures, eliminates the duplication of records, and places the responsibility of asset liquidation on the largest creditor who has an incentive to obtain the maximum possible recovery.[17]

[12] For evidence on the shifting of liabilities in large banks, see Marino and Bennett (1999).

[13] When regulators refrain from taking actions that are normally required by statute, they are adopting a policy of forbearance. The reasons behind using forbearance can be complex. In the United States, regulators have applied forbearance successfully in the past to avoid a financial crisis. Forbearance, however, can create an opportunity for the troubled bank to deteriorate further and may therefore increase resolution costs.

[14] For a discussion of early intervention, see European Shadow Financial Regulatory Committee (1998).

[15] To engage in the business of deposit-taking in the United States, organizations must obtain a charter. The chartering authority for state-chartered banks is usually the state banking department; for national banks, the Office of the Comptroller of the Currency (OCC); and for federal savings institutions, the Office of Thrift Supervision (OTS).

[16] FDICIA gave the FDIC the authority to close any bank that is considered to be critically undercapitalized and that does not have a plan to restore capital to an adequate level. FDICIA also gave the FDIC authority to close any bank that (1) has a substantial dissipation of assets because of the violation of law, (2) is operating in an unsafe and unsound manner, (3) is engaging in a willful violation of a cease-and-desist order, (4) is concealing records, or (5) is no longer insured. Twice the FDIC has closed banks and appointed itself receiver (see note 18). Section 8 of the Federal Deposit Insurance Act provides details of the conditions under which the Board of Directors of the FDIC can terminate deposit insurance.

[17] Chapter 8 of FDIC (1998a) and Chapter 7 of FDIC (1998b) discuss the role of the FDIC as receiver in more detail.

The FDIC not only has the authority to act as a receiver but also, under FDICIA, has the authority to appoint itself as receiver.[18] That authority was given to the FDIC to make it independent of the chartering authorities and able to act in a timely fashion to protect the insurance fund. The deposit insurer has an incentive to protect the insurance fund and therefore might act more swiftly than the supervisory authorities that are not directly accountable for protecting the fund.

As receiver, the FDIC is responsible for settling the affairs of the closed bank or thrift—including (as mentioned above) collecting on the assets of the failed bank and, from the proceeds, satisfying the creditor claims against the receivership. When the FDIC is appointed receiver, it succeeds to the rights, powers, and privileges of the bank. It may collect all obligations and money due to the bank, preserve and liquidate its assets and property, and perform any other function of the bank consistent with being a receiver.

Some of the powers of the FDIC as a receiver of failed banks are similar to those of a bankruptcy trustee, but the FDIC has additional powers that make its role as a receiver critically different from that of a bankruptcy trustee. These additional powers are discussed in the next subsection.

Thirty-seven deposit insurers responded to the following survey question: *Who generally appoints a receiver?* Only 13 of the 37 respondents have a structure similar to that in the United States. These 13 respondents indicated only the central bank, the ministry of finance, or the supervisory authority appoints the receiver. The court appoints a receiver in most of the remaining locations, either alone or in conjunction with the central bank, the ministry of finance, and/or the deposit insurer. In two places (Mexico and Romania) the deposit insurer is solely responsible for appointing a receiver. (See Table 3.)[19]

The survey responses indicate that the role of the FDIC as both insurer and receiver is uncommon. Many countries do not give their deposit insurers the authority to act as receiver. Only 10 of the 36 respondents answered "Yes" to the following survey question: *Does the deposit insurer have the authority to act as the receiver of a failed depository institution?* Of the 10, only 3 operate in advanced economies. (See Table 3.)

The deposit insurer typically does not act as the receiver; in most places a private party acts as receiver, either alone or in conjunction with a government agency other than the deposit insurer. Thirty deposit insurers responded to the following survey question: *If the deposit insurer is not the receiver, is another government agency or a private party the receiver?* Of these 30 respondents, 21 indicated that only a private party is the receiver, 5 indicated a combination of a private party and a government agency, and only 4 indicated a government agency acts alone as receiver.

The deposit insurer rarely has the authority to appoint itself receiver. Of the ten deposit insurers that do have the authority to act as receiver, only three answered "Yes" to the following survey question: *Does the deposit insurer have the authority to appoint itself receiver of the failed depository institution?* Two of these three respondents (Mexico and Uganda) are in developing economies, and one (Canada) is in an advanced economy. (See Table 3.)

Bankruptcy or Receivership Process

As mentioned above, in the United States the liquidation system that is used to resolve a bank differs from bankruptcy proceedings for other types of business entities. The liquidation system is governed by receivership laws that seek to ensure the speedy resolution of banks and that therefore allow the receiver broader powers than the bankruptcy laws allow.

There are many reasons for the FDIC's special powers as a receiver. One is to ensure common standards and uniform expectations among creditors, shareholders, and the public. Another is to allow for prompt reimbursement of insured depositors and a speedy liquidation process. The special powers conferred on the FDIC allow it to expedite the liquidation process for banks and thus maintain confidence in the banking system; for example, the special powers do not allow any of the creditors of the bank to delay closure, although they do have the right to sue the receivership after the closure of the bank. The special powers also allow the FDIC to protect the insurance fund by minimizing receivership costs.

FDIC (1998a) outlines five essential differences between receivership and bankruptcy. These differences involve (1) the claims determination process, (2) contract repudiation, (3) stay of litigation, (4) avoidance powers, and (5) special defenses.

[18] The FDIC has appointed itself receiver twice since 1991: in 1994 and 1999. In 1994 the FDIC closed and appointed itself receiver of the Meriden Trust & Safe Deposit Company in Meriden, Connecticut. For more details, see FDIC (1998a), 181. In 1999 the FDIC closed and appointed itself receiver of Victory State Bank in Columbia, South Carolina.

[19] On Table 3 and many of the subsequent tables, the total number of respondents differs from the sum of the total number of responses in each column because some deposit insurers gave more than one answer.

Table 3
Receivership Authority

Deposit Insurer	Who generally appoints a receiver?[a]				Does the deposit insurer have the authority to act as the receiver of a failed depository institution?		Does the deposit insurer have the authority to appoint itself receiver of a failed depository institution?	
	Court	Central Bank, Ministry of Finance, or Supervisory Authority	Deposit Insurer	Other	Yes	No	Yes	No
Advanced Economies								
Austria (AAR)		X				X		X
Austria (AABB)	X					X		X
Belgium	X					X		X
Canada	X	X			X		X	
France		X				X		X
Germany (EdB)	X					X		X
Germany (E)	X					X		X
Greece		X				X		X
Isle of Man[b]	X					X		X
Italy (IDPF)		X				X		X
Italy (DPFCB)		X				X		X
Japan	X							
Netherlands	X		X			X		X
Portugal				X		X		X
Spain	X				X			X
Sweden	X	X				X		X
Taiwan Province of China		X			X			X
United Kingdom				X		X		X
Subtotal	**10**	**8**	**1**	**2**	**3**	**14**	**1**	**16**
Developing Economies and Economies in Transition								
Africa								
Nigeria		X			X			X
Tanzania		X			X			X
Uganda		X			X		X	
Europe								
Czech Republic	X					X		X
Hungary	X					X		X
Latvia	X					X		X
Lithuania	X	X				X		X
Poland	X					X		X
Romania			X			X		X
Slovak Republic	X					X		X
Turkey		X			X			X
Middle East								
Bahrain	X	X		X		X		X
Oman		X				X		X
Western Hemisphere								
Brazil		X				X		X
El Salvador	X					X		X
Jamaica	X				X			X
Mexico			X		X		X	
Peru		X				X		X
Trinidad and Tobago	X				X			X
Subtotal	**10**	**9**	**2**	**1**	**7**	**12**	**2**	**17**
Total	**20**	**17**	**3**	**3**	**10**	**26**	**3**	**33**

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000).
[a]If entities work together to appoint a receiver, an "X" will appear in more than one column.
[b]British Crown Dependency.
AAR = Association of Austrian Raiffesenbanks
AABB = Association of Austrian Banks and Bankers
EdB = Entschadigungseinrichtung deutscher Banken
E = Einlagensicherungs
IDPF = Interbank Deposit Protection Fund
DPFCB = Deposit Protection Fund for Co-operative Banks

Claims determination process. The FDIC as receiver has the power to allow or disallow claims. If the receiver disallows a claim, the holder has the right to litigate the claim in federal court. In contrast, although a bankruptcy trustee can object to a claim, only the bankruptcy court can allow or disallow claims.

Contract repudiation. The FDIC as receiver has the power, within a reasonable period, to repudiate contracts it deems burdensome. Banks often enter contracts that, at the time of receivership, are burdensome to the receiver in terms of duration or cost. In contrast, a bankruptcy trustee can repudiate only contracts that the parties have not fully executed.

Stay of litigation. After the FDIC has been appointed receiver, it is responsible for any pending litigation against the bank but has the option of requesting a stay of legal proceedings of up to 90 days.

Avoidance powers. Both the FDIC as receiver and a bankruptcy trustee have avoidance powers, or the power to pursue fraudulent transfers and recover property. However, the FDIC as receiver can pursue transfers made five years before or after the date of the receiver's appointment.

Special defenses. To defeat claims, a bankruptcy trustee can use only defenses that are available to the debtor to defeat claims. In contrast, the FDIC as receiver has special statutory defenses it can use. For example, improperly documented agreements are not binding on the receiver: the receiver relies solely on the records of the failed bank to evaluate the assets and liabilities accurately. Being able to disallow improperly documented agreements contributes to the efficiency and cost effectiveness of failure resolutions.

Another important difference between the receivership process and bankruptcy proceedings for other types of business entities is that the FDIC is not subject to the direction or supervision of any other agency or department of the United States in the operation of the receivership. The court does not supervise the administration of the assets and liabilities of the failed bank and cannot review the decisions of the receiver except under limited circumstances.

The granting of special authority to the FDIC as receiver is based on history. Before the FDIC was created, the Office of the Comptroller of the Currency (OCC) supervised the liquidation of national banks, and state banks were liquidated according to state laws, which varied from state to state. Even so, most liquidations of state banks were handled like any other business insolvency. During the 1933 banking crisis in the United States there was a shortage of experienced receivers. In addition, there were concerns that the receivership appointments had been made as political favors. Such appointments were desirable because receivers earned large commissions and therefore had an incentive to extend the receivership work. On average, it took six years to liquidate the assets of a failed bank and to pay depositors.[20] (Depositors were treated like any other creditors in a bankruptcy, receiving funds after the bank's assets had been liquidated.) When Congress created the FDIC, it believed that making the largest creditor (the FDIC) responsible for liquidating the assets of failed banks would simplify procedures. After all, it is in the best interest of the largest creditor to obtain the maximum recovery as quickly as possible.

Outside the United States, most failed banks go through a regular corporate bankruptcy process. Approximately 62 percent of the 37 respondents answered "Yes" to the following survey question: *Does a failed bank go through the regular corporate bankruptcy process?* (See Table 4.) The proportions in both advanced economies and developing economies and economies in transition were roughly similar.

The Least-Cost Requirement and Exceptions to It

The least-cost resolution refers to the resolution method that minimizes the present value of net losses incurred by the deposit insurer, regardless of other factors. Without a least-cost requirement, the choice among resolution methods would involve trade-offs among minimizing the cost of the resolution transaction, imposing market discipline, and limiting risk to the banking sector as a whole. Requiring the deposit insurer to resolve banks in the least costly manner imposes market discipline inasmuch as the deposit insurer must structure resolutions that impose losses on uninsured and unsecured creditors.

However, policy considerations other than cost to the deposit insurer may be important to the deposit insurer. For example, the deposit insurer may be concerned about the systemwide implications of the resolution of a particular bank, especially one that is very large and has many interbank relationships. When such a bank fails, a resolution structure that controls risk to other banks in the financial system may not be

[20] FDIC (1998b), 64.

Table 4
Bankruptcy Process

Deposit Insurer	Does a failed bank go through the regular corporate bankruptcy process? Yes	No
Advanced Economies		
Austria (AAR)	X	
Austria (AABB)	X	
Belgium	X	
Canada		X
France	X	
Germany (EdB)	X	
Germany (E)	X	
Greece		X
Isle of Man[a]	X	
Italy (IDPF)		X
Italy (DPFCB)	X	
Japan		X
Netherlands		X
Portugal		X
Spain	X	
Sweden	X	
Taiwan Province of China	X	
United Kingdom	X	
Subtotal	**12**	**6**
Developing Economies and Economies in Transition		
Africa		
Nigeria		X
Tanzania		X
Uganda	X	
Europe		
Czech Republic		X
Hungary		X
Latvia		X
Lithuania	X	
Poland		X
Romania	X	
Slovak Republic	X	
Turkey	X	
Middle East		
Bahrain		X
Oman	X	
Western Hemisphere		
Brazil		X
El Salvador	X	
Jamaica	X	
Mexico	X	
Peru	X	
Trinidad and Tobago	X	
Subtotal	**11**	**8**
Total	**23**	**14**

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000).

[a]British Crown Dependency.

AAR = Association of Austrian Raiffesenbanks
AABB = Association of Austrian Banks and Bankers
EdB = Entschadigungseinrichtung deutscher Banken
E = Einlagensicherungs
IDPF = Interbank Deposit Protection Fund
DPFCB = Deposit Protection Fund for Co-operative Banks

the least costly to the deposit insurer. A least-cost requirement that has enough flexibility to allow the deposit insurer to deal with systemic risks may be advantageous.

In the United States at the beginning of the 1980s, when the FDIC determined the structure of a resolution, it considered a variety of policy issues and objectives. The four primary ones were (1) to maintain public confidence and stability in the U.S. banking system, (2) to encourage market discipline so as to prevent excessive risk taking, (3) to resolve failed banks in a timely and cost-effective manner, and (4) to be equitable and consistent in using resolution methods. There were also certain secondary objectives, one of which was the desire to minimize the FDIC's role in owning, financing, and managing banks and their assets. After passage of FDICIA, which mandated the least-cost requirement, all policy objectives became secondary to cost considerations in determining the resolution method.[21]

To implement FDICIA, the FDIC evaluates all bids for failed banks solely on the basis of cost, not factoring into the decision any other policy considerations. The FDIC computes the cost of a resolution on a present-value basis, using a realistic discount rate. As discussed later in this section, the one exception to the least-cost test is the "systemic-risk" exception.

Outside the United States, a least-cost requirement like the one imposed on the FDIC is far from universal. Nineteen of the 35 respondents answered "Yes" to the following survey question: *Is the deposit insurer required to resolve failed or failing insured depository institutions in a manner that is least costly to the deposit insurer?* (See Table 5.) Of the respondents in advanced economies, fewer than 50 percent have a least-cost requirement; in developing economies and economies in transition, approximately 63 percent have one.

In the United States, as already mentioned, FDICIA provided for one exception to the least-cost requirement, namely, the systemic-risk exception. Before the FDIC can invoke this exception, two-thirds of the FDIC Board of

[21] Before passage of FDICIA, resolution transactions were subject to a different type of cost test: the FDIC could resolve a bank using any transaction that was less costly than a deposit payoff, except that, if a bank was deemed to be essential to the provision of adequate banking services in the community, the FDIC could vary from the cost test and use a transaction that was more costly than a deposit payoff. Cost was always an important element of the decision on resolution structure, but other considerations (for example, avoiding disruption to the local community or passing more assets to the acquirer) sometimes influenced the choice. Under FDICIA, the FDIC no longer has that flexibility but is required to choose the least costly resolution transaction (except that a "systemic-risk" exception is possible, as discussed below).

Table 5
Least-Cost Test and Exceptions

Deposit Insurer	Is the deposit insurer required to resolve failed or failing insured depository institutions in a manner that is least costly to the deposit insurer?		If yes, under what exceptions, if any, can the deposit insurer deviate from the least-cost approach?			Does either the size of an institution or the fact that it is owned by a governmental entity influence the decision whether and how an insured bank should be resolved?	
	Yes	No	None	Systemic Risk	Other	Yes	No
Advanced Economies							
Austria (AAR)		X					X
Austria (AABB)		X					X
Belgium	X		X				X
Canada	X			X		X	
France	X				X		X
Germany (EdB)		X					X
Germany (E)		X					X
Greece		X				X	
Isle of Man[a]		X					X
Italy (IDPF)	X				X	X	
Italy (DPFCB)	X		X				X
Japan	X				X		X
Netherlands						X	
Portugal		X					X
Spain		X					X
Sweden		X				X	
Taiwan Province of China	X		X			X	
United Kingdom						X	
Subtotal	**7**	**9**	**3**	**1**	**3**	**7**	**11**
Developing Economies and Economies in Transition							
Africa							
Nigeria	X				X	X	
Tanzania	X				X	X	
Uganda	X		X				X
Europe							
Czech Republic		X				X	
Hungary	X		X				X
Latvia		X				X	
Lithuania		X				X	
Poland	X		X				X
Romania		X					X
Slovak Republic		X					X
Turkey	X		X				X
Middle East							
Bahrain		X				X	
Oman	X				X	X	
Western Hemisphere							
Brazil	X				X		X
El Salvador	X			X		X	
Jamaica	X			X		X	
Mexico	X		X			X	
Peru	X			X		X	
Trinidad and Tobago		X					X
Subtotal	**12**	**7**	**5**	**3**	**4**	**11**	**8**
Total	**19**	**16**	**8**	**4**	**7**	**18**	**19**

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000).
[a]British Crown Dependency.
AAR = Association of Austrian Raiffesenbanks
AABB = Association of Austrian Banks and Bankers
EdB = Entschadigungseinrichtung deutscher Banken
E = Einlagensicherungs
IDPF = Interbank Deposit Protection Fund
DPFCB = Deposit Protection Fund for Co-operative Banks

Directors[22] and two-thirds of the Board of Governors of the Federal Reserve System must agree that complying with the least-cost test would have serious adverse effects on economic conditions or financial stability; the two boards forward a written recommendation to the Secretary of the U.S. Treasury; and the Secretary, in consultation with the president of the United States, must agree. Since its creation in FDICIA, the systemic-risk exception has never been used. In imposing this rather stringent requirement, FDICIA clearly outlined the FDIC's options in resolving large banks.

The European Union directives on banking have not yet specifically addressed limits on the bailout of large banks that are considered "too big to fail." In fact, as Murphy (2000) points out, under the current system a large European bank that has a home office in a small country would probably be considered too big to fail. This decision could be made because the cost to the small country of resolving the large bank might be prohibitive.

In locations outside the United States, some flexibility is built into the least-cost requirement. Respondents who have a least-cost requirement answered the following survey question: *Under what exceptions, if any, can the deposit insurer deviate from the least-cost approach?* Of the 19 respondents to the question, 8 said the least-cost requirement cannot be violated for any reason; 4 said it can be violated for reasons of systemic risk; and 7 mentioned other reasons for violating it, including "political interference," "social connections," and "size." (See Table 5.)

In many economies, size or government ownership does affect the nature of the resolution of banks. Eighteen of the 37 respondents answered "Yes" to the following survey question: *Does either the size of an institution or the fact that it is owned by a governmental entity influence the decision whether and how an insured bank should be resolved?* (See Table 5.) Size or government ownership is more likely to influence the resolution decisions in developing economies and economies in transition than in advanced economies (58 percent and 39 percent, respectively).

Types of Resolution

There are two basic types of resolution transactions: open-bank transactions and closed-bank transactions. Closed-bank transactions, in turn, are of two kinds: (1) purchase-and-assumption transactions and (2) deposit payoffs. Another type of resolution is a bridge bank, which is a temporary banking structure that the FDIC controls until it finds a permanent resolution. Bridge banks are not used very often, inside or outside the United States, but in some circumstances they may be useful.

Open-Bank Assistance

In an open-bank assistance (OBA) transaction, the deposit insurer provides financial assistance to the bank while the bank remains open. The assistance can take the form of loans, asset purchases, or a note or cash to restore capital to a positive level; private investors will provide additional capital to restore the bank to an adequate capital position. Consequently, OBA transactions usually require the shareholders to dilute their ownership interests significantly; however, their interests may retain some value, so they could benefit from the government assistance.

The primary advantage of open-bank assistance is that it is least disruptive to the relationships between the bank and its customers. Another advantage is that most of the bank's assets remain in the private sector. Both of these advantages may be particularly important for averting a widespread financial crisis.

Open-bank assistance also has a number of disadvantages. First, it can increase the amount of moral hazard and decrease market discipline within the financial system. Moral hazard may increase because, according to general belief, if a bank thinks it will be bailed out when it gets into trouble, it will take on more risk than if the assistance were not available. Market discipline will be eroded because customers with uninsured and unsecured claims are protected, and shareholders may be partially protected. A second disadvantage is that OBA transactions raise the fairness issue: weak banks are allowed to remain open with government assistance and compete with banks that are not given assistance. Finally, OBA transactions can prove to be somewhat more costly to the deposit insurer: there may be recurring losses, and the process of preparing proposals and completing assistance transactions can be long and difficult.[23]

[22] The Board of Directors of the FDIC is composed of the Comptroller of the Currency, the Director of the Office of Thrift Supervision, and three members appointed by the president of the United States and confirmed by the Senate. One of the appointed members of the Board must have experience supervising state banks. For more detail about the Board of Directors of the FDIC, see Section 2 of the Federal Deposit Insurance Act.

[23] Recurring losses characterized the case of First City Bancorporation. In 1988 the FDIC provided open-bank assistance to resolve the failure of 59 branches of First City, but the bank continued to incur losses. Finally, in 1992, the FDIC used a closed-bank transaction to resolve the bank.

Originally the FDIC provided open-bank assistance to banks that were considered essential to the community. Typically the FDIC would restore capital to a positive level by providing the distressed bank with a cash contribution, an FDIC note, or a loan, and private investors would provide additional capital to restore the bank to an adequate capital position. Because of the restrictions imposed by FDICIA, the FDIC no longer commonly uses OBA transactions. Closed-bank resolutions usually have a cost advantage over open-bank transactions. In a closed-bank transaction, costs are reduced because contingent liabilities are eliminated, burdensome contracts can be terminated, and troublesome assets can be left in the receivership.

Many deposit insurers have the authority to provide open-bank assistance. Of 35 survey respondents, 23 answered "Yes" to the following question: *Do you have the legal authority to provide financial assistance to an operating insured depository institution (open-bank assistance), either as a stand-alone entity or to facilitate an open-bank merger with a healthy insured depository institution?* (See Table 6.) Approximately one-half of the deposit insurers that said "Yes" indicated they have provided financial assistance to an operating bank in the last ten years.

Closed-Bank Resolutions

Closed-bank resolutions—purchase-and-assumption transactions and deposit payoffs—have the advantage of not allowing the problems in the bank to recur. Another advantage is that they are transparent. Deposit payoffs, however, are typically more disruptive to customers of the bank and perhaps the local economy. In purchase-and-assumption transactions, in contrast, there are ways of minimizing the disruption. For example, in the United States, when a bank is resolved by a purchase-and-assumption transaction, the chartering agency usually closes the bank on a Friday and the new bank reopens on Monday. The only change visible to most of the customers of the bank is a change in the name of the bank.

Purchase-and-assumption transactions. A purchase-and-assumption (P&A) transaction is a closed-bank transaction in which a healthy bank purchases some or all of the assets of a failed bank and assumes some or all of the liabilities.[24] The acquirer usually receives assistance from the deposit insurer to complete the transaction. As part of the P&A transaction, the acquiring bank usually pays a premium to the deposit insurer for the deposits it acquires; the premium decreases the total resolution cost to the insurer. The reason the acquirer pays this premium is that the deposit base has value in terms of the established customer relationships, usually referred to as franchise value.[25]

A P&A transaction has some of the advantages of an open-bank assistance transaction while eliminating some of the disadvantages. Like open-bank assistance, a purchase-and-assumption transaction is not disruptive to the customers of the bank. In addition, because most of the assets of the failed bank are transferred to the acquiring bank, they are kept in the private sector.[26] A P&A transaction can maintain market discipline to differing degrees, depending on the structure of the transaction. At the very least, shareholders will lose all of their investment.[27] If all deposits are not transferred to the acquiring bank, uninsured depositors may also incur a loss. However, if uninsured deposits are transferred to the acquiring bank as part of a least-cost transaction, they will be fully reimbursed even though they are uninsured. This transfer is more likely to occur when uninsured deposits are a relatively small portion of the failed bank's total deposits.

Many deposit insurers outside the United States have the authority to use a P&A transaction. Twenty of the 30 respondents answered "Yes" to the following survey question: *Do you have the legal authority to use a P&A transaction in handling failed or failing depository institutions?* (See Table 6.) Ten of these respondents have used a purchase-and-assumption transaction in the last ten years.

Deposit payoffs. In a deposit payoff, the appropriate authority closes the bank, and then the deposit insurer pays all of the failed bank's depositors the full amount of their insured deposits. No assets or liabilities are assumed by another bank; the receiver is responsible for liquidating the assets and paying off the claimants. A deposit payoff may be disruptive to the local community because the depositors are paid

[24] In the United States, banks that are interested in acquiring failed banks must have approval from their primary regulator and must meet the bid criteria established by the FDIC. The FDIC shares a list of eligible bidders with the other regulatory agencies and contacts potential bidders four or five days before the bank closing.

[25] For more detail on the types of P&A transactions the FDIC has used, see FDIC (1998b), chap. 3.

[26] Typically the acquirer will take the higher-quality assets and leave the distressed assets, such as nonperforming loans, in the receivership (see discussion of asset liquidation below).

[27] In the rare case when receivership proceeds remain after all the other claimants are paid in full, shareholders may recover some of their investment.

Table 6
Resolution Methods

Deposit Insurer	Open-Bank Assistance: Has authority	Open-Bank Assistance: Has used authority in past 10 years	Purchase and Assumption: Has authority	Purchase and Assumption: Has used authority in past 10 years	Deposit Payoff: Has authority	Deposit Payoff: Has used authority in past 10 years	Bridge Bank: Has authority	Bridge Bank: Has ever used the authority
Advanced Economies								
Austria (AAR)	X							
Austria (AABB)	X							
Belgium	X		X	X	X	X		
Canada	X	X	X	X	X	X	X	
France	X		X		X		X	
Germany (EdB)					X			
Germany (E)	X		X		X	X	X	
Greece					X	X		
Isle of Man[a]					X	X		
Italy (IDPF)	X	X	X	X	X	X		
Italy (DPFCB)	X	X	X	X	X	X		
Japan	X	X	X		X		X	
Netherlands					X			
Portugal					X			
Spain	X	X	X	X	X	X		
Sweden					X			
Taiwan Province of China	X	X	X	X	X			
United Kingdom								
Subtotal	11	6	9	6	15	8	4	0
Developing Economies and Economies in Transition								
Africa								
Nigeria	X	X	X	X	X	X		
Tanzania	X		X		X			
Uganda	X	X	X	X	X	X		
Europe								
Czech Republic					X	X		
Hungary	X	X	X		X	X	X	
Latvia								
Lithuania					X	X		
Poland	X	X			X	X		
Romania					X	X		
Slovak Republic				X	X	X		
Turkey	X	X	X		X	X	X	
Middle East								
Bahrain								
Oman	X		X		X			
Western Hemisphere								
Brazil								
El Salvador	X		X		X			
Jamaica	X		X		X		X	
Mexico	X	X	X	X	X		X	X
Peru	X		X		X	X		
Trinidad and Tobago	X		X		X	X		
Subtotal	12	6	11	4	16	11	4	1
Total	23	12	20	10	31	19	8	1

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000).
[a]British Crown Dependency.
AAR = Association of Austrian Raiffesenbanks
AABB = Association of Austrian Banks and Bankers
EdB = Entschadigungseinrichtung deutscher Banken
E = Einlagensicherungs
IDPF = Interbank Deposit Protection Fund
DPFCB = Deposit Protection Fund for Co-operative Banks

the insured balance on their accounts as of the time of the bank failure. Any outstanding checks drawn on the accounts are not paid, for there is no successor bank to pay them. The depositors must quickly establish checking accounts in, and lending relationships with, another bank and must arrange with their creditors to cover the unpaid checks. In the United States, the FDIC makes the insured deposits available on the next business day in almost every bank failure.[28] In other countries, depositors are reimbursed over time after the resolution of the bank. The longer depositors must wait to receive their insured funds, the more severe the disruption becomes.[29]

In the United States, there are two types of deposit payoff: a straight deposit payoff and an insured-deposit transfer. In a straight deposit payoff, the FDIC determines the amount of insured deposits and pays each depositor the appropriate amount by issuing a check. In an insured-deposit transfer, the insured deposits are transferred to a healthy bank that is willing to serve as an agent of the FDIC. Depositors may either withdraw their deposits or keep them in the new bank and continue using its deposit services. Banks bid to serve as an agent of the FDIC, hoping to retain some of the customers of the failed bank.

The straight deposit payoff is usually more costly to the deposit insurer than other resolution methods, because all of the failed bank's assets must be liquidated by the receiver and the bank's franchise value is lost. Furthermore, the deposit insurer incurs additional costs from paying off all the insured depositors. Straight deposit payoffs are costly to the customer as well, because (as mentioned above) checks that are in process are not paid. The insured-deposit transfer eliminates the disruption to the customer and the costs of paying off the deposits, but the receiver still incurs the costs of managing and disposing of all the failed-bank assets. The bank that assumes the insured deposits, however, is able to realize some of the franchise value of the failed bank, even if the assuming bank is unwilling to acquire some of the assets (for example, is unwilling to enter into a purchase-and-assumption transaction). A straight deposit payoff is usually used only when no bank is interested in the deposit franchise and an insured-deposit transfer cannot be arranged.

Overall, deposit insurers outside the United States have the authority to pay off depositors, and they use this authority more often than they use any other type of resolution technique. Of the 36 respondents, 31 answered "Yes" to the following survey question: *Do you have the legal authority to use a [deposit] payoff in handling failed or failing insured depository institutions?* (See Table 6.) Nineteen of these respondents have used a deposit payoff in the last ten years.

Bridge banks. In the United States, a bridge-bank transaction is a type of P&A transaction in which the FDIC itself acts temporarily as the acquirer, taking over the operations of a failing bank and maintaining banking services for the customers.[30] As the name implies, the bridge-bank structure 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 bank. Initially the FDIC organizes a bridge bank for up to two years, with the possibility of as many as three one-year extensions.[31] The temporary bridge structure provides the FDIC with time to take control of the business of the failed bank, stabilize the situation, and determine an appropriate permanent resolution. It also enables the FDIC to gain sufficient flexibility for reorganizing and marketing the bank.

A bridge-bank resolution is especially useful in two types of situations: when the failing bank is large or unusually complex, such as a multibank holding company, or when the bank is in a liquidity crisis. In the first situation, a bridge-bank structure allows the condition of the bank to be thoroughly examined and further resolution alternatives to be completely evaluated. Before the failed bank goes into the bridge bank, the FDIC applies the least-cost test, and at this point the uninsured and unsecured creditors suffer losses. The bridge-bank structure also provides additional time for due diligence by all interested potential acquirers. In the second situation (a liquidity crisis), a bridge-bank structure allows the FDIC to assure depositors that their deposits are safe.

A bridge bank operates in a conservative manner while serving the banking needs of the community. Its management goal is to preserve the franchise value and lessen any disruption to the local community. It accepts deposits, makes low-risk loans to regular cus-

[28] Banks are generally closed at the end of business on Friday, and depositors are given access to their funds on the following Monday.

[29] For a discussion of the treatment of depositors at failed banks, see Kaufman and Seelig (2000).

[30] The FDIC Board of Directors selects the chief executive officer of the bridge bank and retains a presence on the bank's board of directors.

[31] Most of the bridge banks created by the FDIC lasted less than seven months. For more detail on the FDIC's experience with bridge banks, see FDIC (1998a), chap. 6.

tomers, and honors the commitments made by the failed bank if those commitments would not create additional losses. By continuing the failed bank's lending relationships, it supports the franchise value of the bank.

Not many deposit insurers outside the United States have bridge-bank authority. Only 8 of the 37 respondents answered "Yes" to the following survey question: *Does the deposit insurer have the authority to temporarily own a bridge bank, an institution into which some or all of the assets and liabilities of a failed insured depository institution can be transferred?* (See Table 6.) Of these 8 respondents, only 1 (Mexico) has ever used its bridge-bank authority. Outside the United States, therefore, a bridge bank is by far the least commonly used resolution technique.

Asset Liquidation

Asset liquidation can be a complex process. To be effective, the receiver must first be familiar with the goals of asset liquidation. The responsibility for asset liquidation must be clearly established as part of the financial safety net. It also is useful if the receiver is familiar with past asset-liquidation experience, in order to determine the most effective manner of marketing the assets to meet the established goals of asset liquidation.

Goals of Asset Liquidation

With the exception of a transaction where the acquirer purchases all of the assets of the bank, all types of closed-bank resolutions require a receiver to liquidate some or all of the assets of the failed bank. Three possible goals of asset liquidation are (1) to sell the assets as quickly as possible, (2) to maximize net present value of the assets in liquidation, and (3) to manage the assets to obtain the highest price.

The three goals can be mutually exclusive. For example, suppose the deposit insurer intends to manage assets to obtain the highest price (meeting goal 3), but prices are currently low. The deposit insurer may keep the assets until the price of the assets increases again, but in doing so the insurer will not be meeting the goal of selling the assets quickly as stated in goal 1. In addition, by holding and managing the assets the insurer will incur costs—including the time cost of money—that will cause the net present value to decline, and the insurer will not meet goal 2.

During the banking crisis in the United States in the 1980s and early 1990s, the FDIC had two basic goals in asset disposition: (1) to dispose of assets as soon as possible and (2) to maximize the return on the receiverships. Disposing of assets quickly minimizes disruption to the public during the resolution of failed banks. Maximizing the return on the receivership minimizes the loss to the insurance fund. These two goals are linked, since disposing of assets quickly allows the receiver to avoid asset-management and servicing costs and any loss in value that might occur simply because the asset is held by a receiver. On the other hand, if there is an excess supply of assets in a market that has depressed prices, disposing of the assets quickly may bring an abnormally low price and thereby a low return on the receivership.

Currently, the FDIC is required by law to minimize the loss to the insurance funds and to maximize the return on the assets of the failed bank or thrift.[32] Beyond these statutory requirements, the FDIC has an incentive to maximize the return on assets of the failed bank: by paying insured depositors and then standing in their place, the FDIC becomes a major creditor of the receivership—typically the largest creditor. Thus, it is in the FDIC's own best interest to maximize the return on assets.

In places outside the United States, obtaining the highest prices for the assets is the most common goal of asset disposition. This goal was mentioned by 11 of the 31 respondents who answered the following survey question: *What is the primary goal of the asset liquidation process (for example, maximize the net present value of assets in liquidation, sell the assets as quickly as possible, manage the assets to obtain the highest price)?* (See Table 7.) The next most often cited goal, mentioned by 10 of the 31 respondents, was to liquidate the assets as quickly as possible; 9 respondents mentioned maximizing the net present value of assets in liquidation; and 8 mentioned satisfying the creditors of the receivership. Most respondents mentioned a combination of asset-disposition goals, indicating that the asset-liquidation process entails several competing goals.

[32] FDICIA contains provisions that explicitly define standards for asset disposition. In Section 123 (amending Section 11 of the FDI Act), FDICIA states that the FDIC shall conduct operations in a manner that (1) maximizes the net present value of return from the sale or disposition of assets, (2) minimizes the amount of any loss realized in the resolution of cases, (3) ensures adequate competition and fair and consistent treatment of those who submit bids for the assets, (4) prohibits discrimination on the basis of race, sex, or ethnic group in the solicitation and consideration of bids, and (5) preserves to the greatest extent possible the availability and affordability of residential real-estate property for low- and moderate-income individuals.

Table 7
Goals of Asset Liquidation

Deposit Insurer	Liquidate the assets as quickly as possible	Maximize the net present value (NPV) of assets in liquidation	Obtain the highest prices for the assets	Satisfy the creditors of the receivership	Other
Advanced Economies					
Austria (AAR)					
Austria (AABB)			X		
Belgium				X	
Canada		X			
France			X		
Germany (EdB)					
Germany (E)					
Greece	X		X		
Isle of Man[a]					X
Italy (IDPF)				X	
Italy (DPFCB)		X		X	
Japan					
Netherlands				X	
Portugal	X		X		
Spain	X				
Sweden					
Taiwan Province of China		X		X	
United Kingdom					
Subtotal	**3**	**3**	**4**	**5**	**1**
Developing Economies and Economies in Transition					
Africa					
Nigeria	X		X		
Tanzania				X	
Uganda	X	X			
Europe					
Czech Republic				X	
Hungary					X
Latvia					X
Lithuania			X		
Poland				X	
Romania			X		
Slovak Republic			X		
Turkey		X			
Middle East					
Bahrain	X	X	X		
Oman					X
Western Hemisphere					
Brazil		X			
El Salvador	X	X			
Jamaica		X			
Mexico	X		X		
Peru	X				
Trinidad and Tobago	X		X		
Subtotal	**7**	**6**	**7**	**3**	**3**
Total	**10**	**9**	**11**	**8**	**4**

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000).
[a]British Crown Dependency.
AAR = Association of Austrian Raiffesenbanks
AABB = Association of Austrian Banks and Bankers
EdB = Entschadigungseinrichtung deutscher Banken
E = Einlagensicherungs
IDPF = Interbank Deposit Protection Fund
DPFCB = Deposit Protection Fund for Co-operative Banks

In most places, the primary goal of asset liquidation is set either by policy or by regulation. Thirty-one respondents answered the following survey question: *Is the primary goal of the asset-liquidation process established by regulation, statute, or policy?* (See Table 8.) Fifteen of the 31 respondents mentioned policy, 14 mentioned regulation, and 4 mentioned statute. Some of the deposit insurers indicated that asset-liquidation goals were established by some combination of regulation, statute, and policy.

Responsibility for Asset Liquidation

Responsibility for asset liquidation can lie with either a government entity or a private party. If the government entity is responsible for asset liquidation, it may be allowed to contract out the responsibility to the private sector. This power is particularly useful if the amount of failed-bank assets that needs to be liquidated is large and/or the number of experienced asset liquidators employed by the government is insufficient. The government may choose to keep its liquidation staff small and contract out to the private sector the greater part of the responsibility. In that case, the challenge is to develop contracts that align the interests of the private asset-management companies with the interests of the government. Such contracts must include provisions for effective monitoring by the government. At the same time, however, for the private sector to operate efficiently, there must be minimal interference from the government. The way to balance these objectives is to have identifiable and measurable performance outcomes. Finally, contractors should be contractually bound to operate fairly, equitably, and legally.

In the United States during the banking crisis of the 1980s and early 1990s, the FDIC used the private sector to manage and liquidate receivership assets.[33] In the peak period of 1988 to 1993, private-sector firms managed more than 45 percent of the FDIC's post-resolution assets.[34] The FDIC designed its asset-management and disposition contracts to facilitate the disposition of distressed and repossessed assets (especially nonperforming loans and owned real estate), using many forms of contracts and modifying them over the years as it gained experience.[35]

Early in the process, the asset-liquidation contracts required payment of the private asset liquidators on a cost-plus basis: the FDIC would reimburse liquidators for all expenses and overhead costs incurred during liquidation and would pay a fixed incentive fee. However, this type of liquidation contract did not

Table 8
Establishing the Goals of Asset Liquidation

	Is the primary goal of the asset-liquidation process established by regulation, statute, or policy?			
Deposit Insurer	Regulation	Statute	Policy	Other
Advanced Economies				
Austria (AAR)				
Austria (AABB)	X			
Belgium				
Canada			X	
France			X	
Germany (EdB)			X	
Germany (E)			X	
Greece			X	
Isle of Man[a]		X		
Italy (IDPF)	X			
Italy (DPFCB)	X			
Japan				
Netherlands	X			
Portugal	X			
Spain		X		
Sweden				
Taiwan Province of China			X	
United Kingdom				
Subtotal	**5**	**2**	**6**	**0**
Developing Economies and Economies in Transition				
Africa				
Nigeria			X	
Tanzania				X
Uganda			X	
Europe				
Czech Republic	X			
Hungary	X			
Latvia	X	X	X	
Lithuania	X			
Poland	X			
Romania				
Slovak Republic	X			
Turkey			X	
Middle East				
Bahrain		X	X	
Oman	X			
Western Hemisphere				
Brazil			X	
El Salvador	X			
Jamaica			X	
Mexico	X			
Peru			X	
Trinidad and Tobago			X	
Subtotal	**9**	**2**	**9**	**1**
Total	14	4	15	1

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000).

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[33] This discussion focuses on the evolution of asset-liquidation contracts at the FDIC. For more information on the development of asset-liquidation and management contracts at the Resolution Trust Corporation (RTC), see FDIC (1998a), chap. 13.

[34] FDIC (1998a), 50.

[35] For details on the evolution of asset-disposition practices, see FDIC (1998b), chap. 12.

give the private asset liquidators any incentive to contain costs. To maximize the net present value of cash flows from the liquidation, the FDIC had to build in incentives for the private contractors to control costs, and more complicated contract structures evolved. For example, incentive fees came to be based on the ratio of net collections to the value of the asset pool. Thus, the FDIC learned from experience to design contracts that more closely aligned contractors' incentives with its own goals of asset liquidation.

In many places the receiver is responsible for the liquidation of assets. Twenty-nine of the 34 respondents answered "Yes" to the following survey question: *Is the receiver responsible for the liquidation of the assets of the receivership?* (See Table 9.) But being responsible for the liquidation does not always mean that the deposit insurer directly liquidates the assets of failed banks. Thirty-seven respondents answered the following survey question: *What role does the deposit insurer have in the asset-liquidation process?* Only 6 of the 37 indicated that the deposit insurer has a direct role in liquidating assets, and 5 of the 6 are located in developing economies and economies in transition. Sixteen of the 37 respondents indicated that the deposit insurer has no role in asset liquidation. The 15 remaining respondents said the deposit insurer oversees asset liquidation, exerts some influence over asset liquidation as a creditor of the receivership, or is involved in asset liquidation in some other capacity.

In some economies, both the public sector and the private sector liquidate assets of failed banks. Sixteen deposit insurers responded to the following survey question: *What percentage of effort involved in selling assets is handled by the private sector (as compared to government employees)?* (See Table 10.) Nine respondents indicated that the private sector handles all the asset sales, and two respondents (Turkey and Brazil) indicated that the private sector does not handle any of the asset sales, but the remaining five said the responsibility for asset sales is shared by the government and the private sector.

Eight deposit insurers responded to the following survey question: *What is the percentage [of effort involved in] asset management [handled by the private sector (as compared with government employees)]?* (See Table 10.) Only one deposit insurer (Isle of Man) indicated that the private sector is solely responsible for asset management; three said the private sector has no involvement; and four said the private sector and the government share the responsibility.

Asset-Liquidation Experience

Typically the assets that remain with the receivership are those that are hardest to liquidate. For example, in a purchase-and-assumption transaction the distressed assets are left in the receivership while the higher-quality assets are taken by the acquirer. Because distressed assets are usually retained in the receivership, they are sold after the resolution is completed. Or, instead of attempting to sell the assets, the receiver can wait for borrowers to repay the troubled loans, or negotiate compromises with the borrowers.

In the United States during the banking crisis of the 1980s and early 1990s, the focus was on attempting to sell the assets. At first, employees at the FDIC managed and liquidated each asset individually. But as the volume of assets held by the FDIC increased, it became less practical to manage and sell individual assets (a $100,000 loan required roughly the same amount of labor as a $1,000,000 loan). So the FDIC gradually developed more-sophisticated methods of liquidating assets; these included selling assets in bulk, providing representations and warranties, forming equity partnerships, and securitizing the sales of assets.[36]

The first step, when it became apparent that selling assets individually was increasingly less practical, was to sell them in bulk: the FDIC began to package together loans with similar characteristics. At that time an established market did not exist for such loan packages, so the FDIC began by creating small packages, ranging from $1 million to $2.5 million in book value. These small packages generated interest and the FDIC gathered information on potential buyers. As the initial buyers gained experience, they were able to attract capital and funding that enabled them to expand their businesses. Gradually, the book value of the loan packages grew, and the FDIC was able to sell large portfolios to an expanded marketplace of buyers.

To facilitate the sale of troubled assets, the FDIC and the Resolution Trust Corporation (RTC) also provided representations and warranties. These are legally binding statements made to buyers to assure them that the assets being sold meet certain minimum quality criteria. If these criteria are not met, the seller is obligated either to cure the condition or to offer a remedy, such as a repurchase or a substitution of another

[36] For more details on the evolution of asset-disposition practices in the United States, see FDIC (1998a), chap. 12.

Table 9

Responsibility for Asset Liquidation

Deposit Insurer	Is the receiver responsible for the liquidation of the assets of the receivership		What role does the deposit insurer have in the asset liquidation process?				
	Yes	No	None	Liquidates assets	Oversees asset liquidation	Exerts influence as a creditor of the receivership	Other
Advanced Economies							
Austria (AAR)			X				
Austria (AABB)	X		X				
Belgium	X		X				
Canada		X			X		
France	X		X				
Germany (EdB)	X					X	
Germany (E)	X					X	
Greece	X		X				
Isle of Man[a]							X
Italy (IDPF)	X						X
Italy (DPFCB)	X						X
Japan	X		X				
Netherlands	X		X				
Portugal	X		X				
Spain	X					X	
Sweden			X				
Taiwan Province of China	X			X			
United Kingdom	X					X	
Subtotal	**14**	**1**	**9**	**1**	**1**	**4**	**3**
Developing Economies and Economies in Transition							
Africa							
Nigeria	X			X			
Tanzania	X			X			
Uganda	X			X			
Europe							
Czech Republic		X	X				
Hungary	X					X	
Latvia		X	X				
Lithuania	X			X			
Poland	X		X				
Romania		X	X				
Slovak Republic	X						X
Turkey	X						X
Middle East							
Bahrain	X		X				
Oman	X						X
Western Hemisphere							
Brazil	X		X				
El Salvador		X		X			
Jamaica	X				X		
Mexico	X				X		
Peru	X		X				
Trinidad and Tobago	X				X		
Subtotal	**15**	**4**	**7**	**5**	**3**	**1**	**3**
Total	**29**	**5**	**16**	**6**	**4**	**5**	**6**

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000).
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Table 10
Private-Sector Involvement in Asset Sales and Management

Deposit Insurer	What percentage of effort involved in selling assets is handled by the private sector (as compared with government employees)?	What is the percentage for asset management?
Advanced Economies		
Austria (AAR)		
Austria (AABB)		
Belgium		0
Canada	100	
France		
Germany (EdB)		
Germany (E)		
Greece		
Isle of Man[a]	100	100
Italy (IDPF)		
Italy (DPFCB)		
Japan		
Netherlands		
Portugal		
Spain	100	
Sweden		
Taiwan Province of China		
United Kingdom		
Developing Economies and Economies in Transition		
Africa		
Nigeria	100	
Tanzania	100	
Uganda	100	
Europe		
Czech Republic	100	
Hungary		
Latvia		
Lithuania	80–100	80–100
Poland	100	
Romania	100	
Slovak Republic		
Turkey	0	0
Middle East		
Bahrain		
Oman		
Western Hemisphere		
Brazil	0	
El Salvador	10	10
Jamaica	70	98
Mexico	30	30
Peru		
Trinidad and Tobago	<1	0
Number of Respondents	16	8

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000).
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asset. Representations and warranties are used when assets are being sold in a secondary market where representations and warranties are customary and where their omission will cause lower prices to be offered for the assets.[37]

Representations and warranties can be as simple as a representation that the seller is the owner of the loan or as complex as a representation and warranty addressing environmental concerns. As an example of the latter, the sellers can offer the buyers the opportunity to perform an environmental inspection before bidding or can offer an indemnification if environmental contamination turns out to be present. Because representations and warranties create ongoing obligations, or contingent liabilities, for the deposit insurer, estimating the expected costs of the transaction may be difficult. Representations and warranties usually include termination dates; thus, the contingent liability of the deposit insurer expires on a particular date.

Another asset-disposition technique used in the United States was equity partnerships: the FDIC structured joint ventures with private investors. The FDIC acted as a limited-liability partner, contributing the asset pools and arranging for financing to the partnership. The private investor contributed both equity capital and asset-management services. Once the partnership's debt was paid off, the proceeds from the assets were split between the partners according to a previously agreed-upon percentage of ownership.[38]

The FDIC and the RTC also successfully used securitization to dispose of a sizable portion of assets. Securitization of assets entails packaging assets with similar features and somewhat predictable cash flows into an interest-bearing security. In the United States in the 1980s, the market for mortgage-backed securities—securities backed by a pool of residential loans—was already well established by the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Marketing mortgage-backed securities was therefore much easier than marketing less-conventional securities that were backed by other assets, such as commercial loans.

In most places, assets of failed banks have been liquidated during the past ten years. Twenty-eight of the 34 respondents answered "Yes" to the following survey question: *Have assets of failed banks been liquidated during the past ten years?* (See Table 11.) Of the 19 respondents in developing economies and economies in transition, four have not liquidated assets of failed banks in the past ten years.

Twenty-eight deposit insurers responded to the follow-up survey question: *If yes, what has been the most commonly used strategy for converting the assets into cash (for example, asset sales, securitizations, compromises with borrowers, loan repayments, sale to the bank that takes deposits)?* Nineteen of the 28 respondents mentioned asset sales; eight mentioned loan repayments; eight mentioned selling the assets to banks that take deposits; and one mentioned the securitization of assets. (See Table 11.)

The choice of strategy for disposing of assets is influenced by many factors. Twenty-seven deposit insurers responded to the following survey question: *What factors influence the determination of the strategy used to dispose of assets?* (See Table 12.) Eight indicated that the nature and quality of the assets influenced the disposition strategy, and three mentioned the size and condition of the market for failed-bank assets. Four of the respondents, however, indicated that the strategy was determined case by case. Overall, the reasons for using particular asset-disposition strategies were varied.

The survey respondents found that nonperforming loans and owned real estate were the two most difficult assets to liquidate. Twenty deposit insurers responded to the following question: *What types of assets have you found to be the most difficult to dispose of?* (See Table 13.) Five of the respondents indicated nonperforming loans and five indicated owned real estate. Also mentioned were commercial and industrial loans and commercial and industrial real estate. Many of the respondents indicated that these assets were hard to dispose of either because they were large relative to the economy or because encumbrances made them hard to market.

[37] For more information on representations and warranties, see Moreland-Gunn et al. (1995).

[38] For more detail on the use of equity partnerships in the United States, see FDIC (1998a), chap. 17.

Table 11
Asset-Liquidation Experience

Deposit Insurer	Have assets of failed banks been liquidated during the past 10 years?		If yes, what has been the most commonly used strategy for converting the assets into cash (for example, asset sales, securitizations, compromises with borrowers, loan repayments, sale to bank that takes deposits)?					
	Yes	No	Asset sales	Securitizations	Compromises with borrowers	Loan repayments	Sale to bank that takes deposits	Strategy decided case by case
Advanced Economies								
Austria (AAR)		X						
Austria (AABB)	X							X
Belgium	X		X				X	
Canada	X		X		X	X		
France	X							X
Germany (EdB)	X							X
Germany (E)	X							X
Greece	X		X		X	X		
Isle of Man[a]	X		X					
Italy (IDPF)	X						X	
Italy (DPFCB)	X						X	
Japan								
Netherlands								X
Portugal								
Spain	X		X					
Sweden	X							X
Taiwan Province of China		X						
United Kingdom	X							
Subtotal	**13**	**2**	**5**	**0**	**2**	**2**	**3**	**6**
Developing Economies and Economies in Transition								
Africa								
Nigeria	X		X			X		
Tanzania	X		X			X		
Uganda	X		X			X	X	
Europe								
Czech Republic	X		X				X	
Hungary	X		X					
Latvia	X		X	X	X	X	X	
Lithuania	X		X			X		
Poland	X		X				X	
Romania	X		X					
Slovak Republic		X						
Turkey	X		X		X			
Middle East								
Bahrain		X						
Oman		X						
Western Hemisphere								
Brazil		X						
El Salvador	X		X				X	
Jamaica	X				X			X
Mexico	X		X					
Peru	X		X			X		
Trinidad and Tobago	X		X					
Subtotal	**15**	**4**	**14**	**1**	**3**	**6**	**5**	**1**
Total	28	6	19	1	5	8	8	7

Note: Classification of economies into “Advanced,” “Developing,” or “Economies in Transition” is from International Monetary Fund (2000).

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Table 12
Reasons for Using Asset-Sales Strategy

Deposit Insurer	What factors influence the determination of the strategy used to dispose of assets?						
	Nature and quality of the assets	Minimizing the time to reimburse depositors	Statute, regulation, or policy	Size or condition of the asset market	Macroeconomic conditions, interest rates, state of credit markets	Factors differ case by case	Other
Advanced Economies							
Austria (AAR)							
Austria (AABB)							
Belgium		X					
Canada				X	X		X
France						X	
Germany (EdB)						X	
Germany (E)						X	
Greece							
Isle of Man[a]							X
Italy (IDPF)							
Italy (DPFCB)							X
Japan							
Netherlands							
Portugal							
Spain	X				X		
Sweden							X
Taiwan Province of China	X		X				X
United Kingdom							
Subtotal	2	1	1	1	2	3	5
Developing Economies and Economies in Transition							
Africa							
Nigeria	X						
Tanzania	X		X				X
Uganda	X			X			
Europe							
Czech Republic							X
Hungary							
Latvia							
Lithuania			X				
Poland		X					
Romania			X				
Slovak Republic							
Turkey	X						X
Middle East							
Bahrain						X	
Oman							X
Western Hemisphere							
Brazil							
El Salvador				X			
Jamaica	X						
Mexico							X
Peru					X		
Trinidad and Tobago	X						
Subtotal	6	1	3	2	1	1	5
Total	8	2	4	3	3	4	10

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000).
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Table 13
Types of Assets Most Difficult to Liquidate

Deposit Insurer	What types of assets have you found to be the most difficult to dispose of?							
	Loans	Non-performing loans	Owned real estate	Commercial and industrial loans	Commercial and industrial real estate	Bank premises	Obsolete assets	Other
Advanced Economies								
Austria (AAR)								
Austria (AABB)								
Belgium								
Canada				X				X
France								
Germany (EdB)								
Germany (E)								
Greece								
Isle of Man[a]								
Italy (IDPF)		X						
Italy (DPFCB)		X						
Japan								
Netherlands								
Portugal								
Spain		X						X
Sweden								
Taiwan Province of China				X				
United Kingdom								
Subtotal	**0**	**3**	**0**	**2**	**0**	**0**	**0**	**2**
Developing Economies and Economies in Transition								
Africa								
Nigeria					X		X	
Tanzania			X					
Uganda			X					
Europe								
Czech Republic	X							
Hungary								
Latvia								
Lithuania								
Poland		X						
Romania						X		
Slovak Republic								
Turkey								X
Middle East								
Bahrain								
Oman								
Western Hemisphere								
Brazil								
El Salvador			X					
Jamaica					X			
Mexico	X	X	X	X	X	X	X	X
Peru							X	
Trinidad and Tobago			X					
Subtotal	**2**	**2**	**5**	**1**	**3**	**2**	**3**	**2**
Total	2	5	5	3	3	2	3	4

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000).
[a]British Crown Dependency.
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Conclusions

The results of the survey of deposit insurers clearly indicate that, compared with other deposit insurers, the FDIC has a unique role in resolving bank failures and disposing of failed-bank assets. In contrast to the FDIC's role as a receiver, in other places the court establishes a receivership and court-appointed receivers run the receivership. The FDIC's authority to act as receiver of a failed bank, and the special powers it possesses as receiver, allow it to reimburse insured depositors quickly and to expedite the asset-liquidation process. However, these additional powers should not, and do not, go unchecked.

One check is a least-cost requirement. The FDIC is allowed to deviate from the least-cost requirement only if a systemic-risk determination has been made. In places outside the United States, some flexibility is built into the least-cost test: many deposit insurers are allowed some exceptions to their least-cost requirement.

In arriving at the least costly resolution, the FDIC has authority to choose among various types of resolution structures. Deposit insurers in other places also have some flexibility in the type of resolution they can choose. Most commonly, insurers have the authority to use open-bank assistance or a deposit payoff, but many can also use a P&A transaction. Not many deposit insurers have the authority to use a bridge-bank structure. Consistent with the general finding that deposit insurers act as paying agents and not as receivers, the most commonly used resolution type outside the United States is a deposit payoff.

Even so, some deposit insurers have liquidated failed-bank assets in the past ten years, and for these insurers, the assets hardest to liquidate are the same types that are hardest to liquidate in the United States. Perhaps the experience of the FDIC and the RTC in liquidating failed-bank assets, and the techniques they created during the U.S. banking crisis of the 1980s and early 1990s, will help other locations to market distressed assets in the future.

More generally, despite the uniqueness of the FDIC's role in resolving failed banks, the FDIC's experience may be helpful to other countries that are designing financial safety nets. Of course, it is crucial to take into account each country's political, cultural, and market infrastructure. Nevertheless, some of the resolution and asset-liquidation techniques developed by the FDIC can very likely be applied effectively in other countries.

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Merchant Banking: Past and Present

by Valentine V. Craig*

Merchant banking has been a very lucrative—and risky—endeavor for the small number of bank holding companies and banks that have engaged in it under existing law. Recent legislation has expanded the merchant-banking activity that is permissible to commercial banks and is therefore likely to spur interest in this lucrative specialty on the part of a greater number of such institutions. Although for much of the past half-century commercial banks have been permitted (subject to certain restrictions) to engage in merchant-banking activities, the term *merchant banking* itself is undefined in U.S. banking and securities laws and its exact meaning is not always clearly understood.

This article begins by defining merchant banking and provides a short history of it. The article then looks at the private equity market in the United States, examining that market in terms of its evolution, typical uses of funds, and forms taken by the investments. (In examining the private equity market, one needs to be aware that the private equity market is, in fact, private. Data are limited and could be subject to error.) Discussed next is commercial bank involvement in merchant banking: the structure of commercial bank involvement, the evolution of that involvement, and the recent track record. The major provisions of the Gramm-Leach-Bliley Act of 1999, legislation which authorizes financial holding companies to engage in merchant banking, is looked at next. The final section focuses on the relationship among merchant banking, risk, and the regulators.

Definition and Early History of Merchant Banking

Although not defined in U.S. federal banking and securities laws, the term merchant banking is generally understood to mean *negotiated private equity investment by financial institutions in the unregistered securities of either privately or publicly held companies*. Both investment banks and commercial banks engage in merchant banking, and the type of security in which they most commonly invest is common stock. They also invest in securities with an equity participation feature; these may be convertible preferred stock or subordinated debt with conversion privileges or warrants. Other investment bank services—raising capital from outside sources, advising on mergers and acquisitions, and providing bridge loans while bond financing is being raised in a leveraged buyout (LBO)—are also typically offered by financial institutions engaged in merchant banking.

Merchant banks first arose in the Italian states in the Middle Ages,[1] when Italian merchant houses—generally small, family-owned import-export and commodity trading businesses—began to use their excess capital to finance foreign trade in return for a share of the profits. This trade generally consisted of lengthy

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[1] Much of the history of merchant banking is derived from Banks (1999).

sea voyages. Thus, the investments were very high risk: war, bad weather, and piracy were constant threats, and by their nature the voyages were long-term and illiquid.

Later, the center for merchant banking shifted from the Italian states to Amsterdam and then, in the eighteenth century, to London, where immigrants from Prussia, France, Ireland, Russia, and the Italian states formed the core of early British merchant banking. Like the Italian and Dutch houses before them, these British houses were generally small, family-owned partnerships, and most of them continued both to trade for their own businesses and to finance the trading by others. By the end of the eighteenth century, however, the British merchant houses had increased in size and sophistication and began specializing in trade, marketing, or finance. As the nineteenth century opened, virtually no mercantile houses remained focused on both trade and finance.

The Private Equity Market in the United States

The private equity market in the United States has evolved over the years, with financial institution involvement only becoming significant in the 1960s and 1970s. Where these funds are invested also has changed over time. Currently, most private equity funding is used to fund start-up or early-stage companies or to bring large public companies private. Private equity investments can be made through limited partnerships or they can be direct investments. Subsidiaries of banking organizations are probably the largest direct investors in this market.

Evolution of the Private Equity Market

Given its history, merchant banking is often thought of as a European, and especially British, financial specialty, and British institutions continue to maintain a major presence in this area. Since the 1800s and even earlier, however, U.S. firms (such as J.P. Morgan) also have been active in merchant banking. However, although both investment banks and commercial banks, as well as other types of businesses, have been authorized to engage in private equity investment in the United States, financial institutions have not been major providers of private equity.

Until the 1950s, U.S. investors in private equity were primarily wealthy individuals and families. In the 1960s and 1970s, corporations and financial institutions joined them in this type of investment. (In the 1960s, commercial banks were the major providers of one kind of private equity investing, venture-capital financing.) Through the late 1970s, wealthy families, industrial corporations, and financial institutions, for the most part investing directly in the issuing firms, constituted the bulk of private equity investors.

In the late 1970s, changes in the Employee Retirement Income Security Act (ERISA) regulations, in tax laws, and in securities laws brought new investors into private equity. In particular, the Department of Labor's revised interpretation of the "prudent man rule" spurred pension fund investment in private equity capital.[2] Currently, the major investors in private equity in the United States are pension funds, endowments and foundations, corporations, and wealthy investors; financial institutions—both commercial banks and investment banks—represent approximately 20 percent of total private equity capital, divided approximately equally between the two. The U.S. Department of the Treasury (Treasury) estimates that at year-end 1999, commercial banks accounted for approximately $35 billion to $40 billion, and investment banks for approximately another $40 billion, of the $400 billion total investment in the private equity market.

At $400 billion as of year-end 1999, the private equity market is approximately one-quarter the size of the commercial and industrial bank-loan market and the commercial-paper market.[3] In recent years, funds raised through private equity have approximately equaled and sometimes exceeded funds raised through initial public offerings and public high-yield corporate bond issuance.[4] The market also has grown dramatically in recent years, increasing from approximately $4.7 billion in 1980 to its 1999 figure. Despite this tremendous growth, the private equity market is extremely small compared with the public equity market, which was approximately $17 trillion at year-end 1999.

Typical Uses of Private Equity

Private equity financing is an alternative to raising public equity, issuing public debt, or arranging a private placement of debt or bank loan. The reasons

[2] The "prudent man rule" refers to the fiduciary responsibility of investment managers. In the earlier interpretation, each investment in a portfolio was expected to meet safety standards in and of itself. Under the revised interpretation, the Department of Labor accepted the concept of portfolio diversification of risk, thereby permitting portfolio managers to invest a small portion of the portfolio in riskier investments as long as the portfolio in the aggregate met fiduciary standards of risk.

[3] Fenn, Liang, and Prowse (2000).

[4] Ibid.

Table 1
U.S. Private Equity Funds Raised by Year
($ Billions)

Year	Total Private Equity	Venture Capital	Buyout/Mezzanine Financing[a]	Other
1999	$108.1	$46.6	$44.6	$16.9
1998	105.4	28.0	61.2	16.3
1997	73.8	15.7	48.7	9.4
1996	45.2	10.6	29.8	4.9
1995	41.1	8.2	27.3	5.6
1994	30.9	7.2	20.5	3.2
1993	22.0	3.9	16.9	1.2

Source: Venture Economic News.

[a]Mezzanine financing generally consists of subordinated debt with equity conversion privilege or warrants issued in tandem with the equity issue in a buyout.

companies seek private equity financing are varied. For example, other forms of financing may be unavailable or too expensive because the company's track record is either nonexistent or poor (that is, the company is in financial distress). Or a private company may want to expand or change its ownership but not go public. Or a firm may not want to take on the fixed cost of debt financing.

Public firms may seek private equity financing when their capital needs are very limited and do not warrant the expense, time, and regulatory paperwork required for a public issue. They also may seek private equity to keep a planned acquisition confidential or to avoid other public disclosures. They may use the private equity market because the public market for new issues in general is bad or because the public equity market is temporarily unimpressed with their industry's prospects. Finally, very often in recent years, managements of large public firms have felt their firms will benefit from a change in capital structure and ownership and will choose to go private by means of a leveraged buyout (LBO).[5]

Although companies seek private equity for all these reasons, most private equity funding has been used for one of two purposes: to fund start-up or early-stage companies (venture capital) or to bring large public companies private in LBOs. Of the $400 billion in outstanding private equity investment at year-end 1999, venture-capital investments accounted for approximately $125 billion and nonventure-capital investments for approximately $275 billion. LBOs were by far the most common use of nonventure-capital private equity.

Table 1 provides estimates of the private equity raised, and its uses, for each year from 1993 to 1999. From the table one can see that private equity investment increased substantially over this seven-year period, going from $22 billion raised in 1993 to over $108 billion raised in 1999. In 1999, for the first time since 1985, venture-capital fundraising accounted for a larger percentage of total private equity fundraising than buyout/mezzanine financing. Before the mid-1980s, two-thirds of private equity investments were used to finance venture-capital investments.

Forms Taken by Investments

Currently, more than 80 percent of private equity investments are made by limited partnerships, with professional private equity managers acting on behalf of institutional investors. In a limited partnership, the professional equity managers serve as general partners, and the institutional investors serve as limited partners. The general partners manage the investment and contribute an insignificant part of the investment, generally approximately 1 percent. These limited partnerships have a contractually fixed life, usually ten years. The investments are highly illiquid over the partnership's life, with a return not expected until the partnership's later years, when the business

[5] A leveraged buyout is the purchase of a company's stock or assets by a very leveraged acquirer, one whose debt financing is based solely on the value of the acquired firm. The LBO began as a means for the owners of small, privately held companies to cash out and shift ownership to family or management when these buyers did not have much equity capital (the major LBO transactions of the 1970s). Today's LBOs more typically involve bringing large public companies private, with a small group of investors acquiring most of a firm's common stock and issuing a combination of private equity and a large amount of debt, much of it junk bonds.

is sold through a public offering or a private sale, or the shares are repurchased by the company. Banks (through subsidiaries) often act as limited partners in private equity limited partnerships, and infrequently as general partners.

Direct investments in private equity are made also. Through subsidiaries, bank holding companies and banks are probably the largest direct investors in the private equity market.

Commercial Bank Involvement in Merchant Banking

Commercial banks have historically utilized Small Business Investment Corporations (SBICs) or "5 percent subs" (defined below) for their domestic private equity investments, and Edge Act Corporations or foreign subsidiaries to make their foreign private equity investments. Several very large bank holding companies have come to dominate merchant banking, directing as much as 10 percent of their capital to these activities. For the most part, reported earnings from these merchant-banking activities have been very good.

Structure

Before passage of the Gramm-Leach-Bliley Act (GLBA), commercial banks and bank holding companies (BHCs) had two primary vehicles for making private equity investments in domestic corporations. They could make these investments through SBICs and/ or through "5 percent subs." Typically, banks engaged in domestic merchant banking have used both of these vehicles; for equity investments in foreign companies, they have used foreign subsidiaries or Edge Act Corporations. As mentioned above, although these subsidiaries have sometimes organized limited partnerships in which they acted as general partners, more often they have invested directly in private equity or have acted as limited partners in a partnership.

Small Business Investment Corporations. SBICs were authorized by the Small Business Investment Act of 1958 to promote small-business equity funding. This act authorized BHCs and banks to provide equity capital to small companies through SBICs, which can be subsidiaries of either BHCs or banks. A very significant percentage of the largest SBICs are subsidiaries of banks rather than of BHCs.

Investments in SBICs are direct and subject to certain limits. Banks are allowed to invest only 5 percent of their capital and surplus in their SBICs; bank holding company investments are capped at 5 percent of the BHC's interest in the capital and surplus of its subsidiary banks. The investments of the SBICs also are limited. Investments can be made only in companies with pre-investment net worth of no more than $18 million, and each investment is capped at 50 percent of the recipient's outstanding shares of stock.

5 Percent Subs. The Bank Holding Company Act of 1956 permitted bank holding companies to make passive equity investments in nonfinancial companies. Specifically, the legislation allowed bank holding companies to own a maximum of 5 percent of the voting shares (hence the "5 percent sub" designation) and a maximum of 25 percent of the total equity of companies engaged in any activity. There is no limit on the total amount of equity that a BHC can invest through all of its 5 percent subs.

Because these investments are passive equity interests only, bank holding companies often have used unregulated independent general partners to oversee them. And because of the 5 percent sub investment limits, in the case of growing businesses 5 percent subs often have been forced to raise outside capital and limit their role to that of a minority investor or agent.

Foreign Subsidiaries or Edge Act Corporations. As mentioned above, banks have made private equity investments in foreign firms through foreign subsidiaries of bank holding companies or through Edge Act Corporations, which are generally organized as bank subsidiaries. Edge Act Corporations are permitted to own up to 20 percent of the voting shares or 40 percent of the total equity of a foreign company.

Evolution

A few very large BHCs dominate merchant banking, directing as much as 10 percent of their capital to these activities. Citigroup, Chase, Bank of America, FleetBoston, and Wells Fargo have the largest presence in this area. In 1999, Chase, FleetBoston, Wells Fargo, J.P. Morgan, and First Union reported an aggregate investment of over $5 billion in venture-capital investments, and they expect to continue to expand this area of their business.[6]

[6] What's Really Driving Banks' Profits (2000).

Many banks entered merchant banking in the 1960s to take advantage of the economies of scope produced when private equity investing is added to other bank services, particularly commercial lending. As lenders to small and medium-sized companies, banks become knowledgeable about individual firms' products and prospects and consequently are natural providers of direct private equity investment to these firms. As mentioned above, commercial banks were the largest providers of venture capital in the 1960s.

In the middle to late 1980s, the decision to enter merchant banking was thrust on other banks and bank holding companies by unforeseen events. In those years, as a result of the LDC (less-developed-country) debt crisis, many banks received private equity from developing nations in return for their defaulted loans. At that time, many of these banks set up merchant-banking subsidiaries to try to get some value from this private equity.

Also at about that time, most commercial banks began refocusing their private equity investments to middle-market and public companies (often low-tech, already profitable companies) and, rather than providing seed capital, financed expansion or changes in capital structure and ownership. Most particularly, they took equity positions in LBOs, takeovers, or recapitalizations or provided subordinated debt in the form of bridge loans to facilitate the transaction. Often they did both. Commercial banks financed much of the LBO activity of the 1980s.

Then, in the mid-1990s, major commercial banks began once again focusing on venture capital, where they had substantial expertise from their previous exposure to this kind of investment. Some of these recent venture-capital investments have been spectacularly successful. For example, the Internet search engine Lycos was a 1998 investment of Chase Manhattan's venture-capital arm.

Recent Track Record

Commercial banks are permitted to report either realized or unrealized gains on their merchant-banking portfolios, as long as they are consistent in the reporting.[7] This option makes it difficult for one to compare different entities' financial results and could lead to an overly liberal reporting of profits. However, the Federal Reserve Board (FRB) generally considers bank holding companies that are engaged in merchant banking to have reported their earnings conservatively on these equity investments.

These reported earnings have been good. The FRB estimates that revenue from private equity investment for the small number of BHCs with a significant presence in this field[8] was approximately 12 percent to 13 percent of total BHC net income in the three-year period from 1995 through 1997. The FRB further estimates that rates of return on merchant-banking activities have averaged approximately 30 percent annually over the past five years. Another source, the National Venture Capital Association, estimates an overall 85 percent rate of return for venture capital funds invested in early-stage companies in 1999.[9] Most bank subsidiaries' venture-capital investments have recently been averaging returns of approximately 40 percent, compared with 10 percent to 15 percent on commercial lending.[10]

The merchant-banking subsidiaries of Chase, Wells Fargo, J.P. Morgan, First Union, and FleetBoston reported in the aggregate $5 billion in net income for 1999. Chase's merchant-banking subsidiary Chase Capital Partners reported $2.5 billion in net income in 1999—22 percent of Chase's total reported net income. Wells Fargo's merchant-banking activities accounted for 13 percent of its 1999 reported income; J.P. Morgan's for 15 percent; First Union's for 8 percent; and FleetBoston's for 9 percent.

These merchant-bank subsidiary returns are particularly good when one considers that merchant banking requires very low overhead. For instance, Wells Fargo has 92,000 employees, but only 14 partners ran its merchant-bank subsidiary, which was responsible for 16 percent of Wells Fargo's total fourth-quarter 1999 net income. Similarly, First Union has 70,000 employees, but only 16 people conducted its merchant-banking activities, which brought in 13 percent of First Union's fourth-quarter 1999 net income.[11]

With the long bull market in stocks—and a particularly hot IPO market for technology stocks in 1999—BHC merchant-banking subsidiaries have increased their venture-capital investments in recent years. As already mentioned, Chase, Wells Fargo, J.P. Morgan, First Union, and FleetBoston invested over $5 billion

[7] Unrealized gains generally occur after a company has an initial public offering (IPO) but the stock has not been sold because of its lock-up period. A bank would typically apply a discount, or "haircut," to the value of the unsold IPO shares to account for volatility, with the gain being the difference between this discounted value and the investment's cost.

[8] The FRB does not identify the institutions or their individual financial information.

[9] *The New York Times* (1999).

[10] What's Really Driving (2000).

[11] Ibid.

in venture-capital investments in 1999 and plan to continue to expand this area of their business. Chase alone has tripled its venture-capital investments since 1996.[12]

The Gramm-Leach-Bliley Act of 1999

To some extent, commercial bank activities have been restricted throughout U.S. history.[13] Restrictions of particular importance to banks' merchant-banking activities are contained in the 1933 Glass-Steagall Act,[14] which formalized the separation between commercial banking and certain investment-banking activities. Blaming bank failures of the 1930s on the banks' speculative securities activities, Congress passed this legislation to draw a firm line between commercial and investment banking. Although there is little evidence that the investment-banking activities of commercial bank affiliates actually were a major factor in the bank failures of that time, differences of opinion have continued to exist between those who seek to exclude commercial banks from investment-banking activities and those who favor permitting such activities. GLBA, enacted on November 12, 1999, specifically recognizes merchant banking as an activity "financial in nature" and provides authority to financial holding companies (FHCs) to provide merchant-banking services. (The legislation does not define merchant banking.) To qualify as a financial holding company, a bank holding company and all of its insured depository subsidiaries must be well-capitalized and well-managed and its Community Reinvestment Act rating must be at least satisfactory. According to the FRB, as of May 2000, 270 domestic banking institutions and 17 foreign banking organizations had filed to become financial holding companies.[15]

GLBA specifically authorizes FHCs to "directly or indirectly acquire or control any kind of ownership interest in an entity engaged in any kind of trade or business whatsoever" if (1) the shares are purchased and held through a securities affiliate or "an affiliate thereof" of the FHC; (2) the shares are held for the sole purpose of appreciation and ultimate resale; and (3) the FHC does not routinely manage the company in which it has invested except as necessary to obtain an ultimate reasonable return on investment.

Maintaining the historical separation between banking and commerce, this legislation specifically disallows routine management by the FHC subsidiary of the nonfinancial company in which it has invested. These investments are for investment purposes only and are not to be used as a back door for the holding company to control or operate a commercial business. This legislation also prohibits subsidiaries of banks from engaging in merchant-banking activities, although that prohibition may be reexamined by the FRB and the Treasury in 2004.

Under the new law, FHCs' portfolio investments in nonfinancial companies are not limited to the 5 percent sub limits restricting control of the portfolio company. In a major departure from existing policy regarding 5 percent sub investments, GLBA provides that investments made under the new law need not be passive; FHCs may in fact purchase a controlling interest in a company. Nor does GLBA restrict these merchant-banking subsidiaries to SBIC investment limits on the size of the company in which the SBIC can invest, on the percentage of shares that can be owned, and on the amount of BHC or bank capital devoted to these investments.

Final Word: Attention to Risk

GLBA opens up new opportunities for commercial banks that wish to enter or expand their merchant-banking activities. For the most part, pre-GLBA commercial bank merchant-banking activities were very lucrative, and often spectacular. However, in the years 2000–2001 the stock market and the IPO market became substantially more volatile. It is hoped that this greater volatility will emphasize to newer merchant-banking participants the risky nature of this market. Participants might also pay heed to the fact that in the not-so-distant past some financial institutions engaged in merchant banking suffered substantial losses, albeit in their nonventure-capital investments. In particular, in 1990, with the collapse of Drexel Burnham Lambert and the junk-bond market, First Boston's losses were so severe that Credit Suisse, its parent, had to launch a multimillion-dollar rescue. In that same year, Merrill Lynch left the merchant-banking business altogether.

The FRB and the Treasury have been concerned with the increased risks to which merchant-banking activities expose commercial banks. Although GLBA

[12] Ibid.

[13] For more information on this issue, see Blair (1994).

[14] Sections 16, 20, 21, and 32 of the Banking Act of 1933 are commonly referred to as the Glass-Steagall Act.

[15] Ferguson (2000).

was largely silent on limitations to banks' merchant-banking activities, the FRB and the Treasury have not been. On March 17, 2000, the FRB and the Treasury jointly adopted an interim rule implementing the merchant-banking authority of the GLBA: the interim rule placed a cap on the amount of merchant-banking investments that financial holding companies may hold. Specifically, the interim rule placed an aggregate limit of $6 billion or 30 percent of Tier 1 capital on the amount the FHC may devote to merchant-banking activities. In addition, the interim rule required that investments be sold within ten years—although this time limit could be extended on a case-by-case basis.

Merchant-banking participants expressed vehement opposition to the FRB–Treasury interim rule's restrictions on the amount and time limit of merchant-banking investments. On January 10, 2001, the FRB and the Treasury issued a final rule replacing the earlier interim rule. The final rule removed the $6 billion cap on merchant-banking investments of financial holding companies. Although the final rule maintained the ten-year limit on investments, the rule simplified ways to obtain extensions to this limit.

The FRB also offered for comment last year a proposal that would have required FHCs to set aside significant capital for their merchant-banking investments. A capital charge of 50 percent on all non-trade-account equities held by banking organizations was proposed. Merchant-banking participants expressed particular opposition to this proposed rule. On January 18, 2001, the FRB released a revised proposal. It proposed a sliding scale tying a company's capital requirements to the amount of its equity investments in nonfinancial companies. The proposed scale ranges from an 8 percent capital charge for equity investments of up to 15 percent of Tier l capital; a 12 percent capital charge for equity investments of between 15 percent and 25 percent of Tier l capital; and a maximum 25 percent capital charge for those banking companies with equity investments exceeding 25 percent of Tier 1 capital. These capital charges also are to be applied to equity investments by banks and BHCs made under other authorities besides GLBA.[16] An exception applies to SBIC investments. Under the proposal, no capital charge would be required for SBIC investments if they do not exceed 15 percent of the organization's capital.[17] The FRB also issued regulations prohibiting FHCs from cross-marketing with any company in which the BHC makes a merchant-banking investment that exceeds 5 percent of the company's equity.

Observers will be paying close attention to how the FRB proceeds regarding FHC merchant-banking activity, as this represents the latest chapter in the debate over the mixing of banking and commerce in the United States. How banks fare in their merchant-banking activities during the next economic downturn will also be followed with great interest.

[16] These capital charges apply to some investments held by state banks under Section 24 of the Federal Deposit Insurance Act. Section 24(d) allows a state bank to hold, through subsidiaries, equity investments that are not permissible for a national bank if the investment poses no harm to the deposit fund and the bank is and continues to be in compliance with applicable capital standards. Under the proposed rule, the FDIC may permit a lower capital deduction for such investments under Section 24 in certain instances. The FDIC and the other banking agencies also reserve the authority to impose higher capital charges where appropriate.

[17] Also exempt are investments held under Section 24(f) of the Federal Deposit Insurance Act. Section 24(f) permits state banks to retain and acquire stock that does not exceed 100 percent of the bank's capital if the bank is located in a state that permitted, as of September 30, 1991, investment in publicly traded companies and registered investment companies, and the bank made or maintained an investment in such securities during the period beginning September 30, 1990, and ending November 26, 1991.

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Recent Developments Affecting Depository Institutions

by Lynne Montgomery*

REGULATORY AGENCY ACTIONS

Interagency Actions

Consumer-Protection Rule for Insurance

The federal bank and thrift regulatory agencies announced on December 4, 2000, a final consumer-protection rule for the sale of insurance products by depository institutions. The rule outlines disclosures that are required before the completion of the sale of an insurance product or annuity. The rule applies to any depository institution and any person selling, soliciting, advertising, or offering insurance products or annuities to a consumer at an office of the institution or on behalf of the institution. The disclosures must be made orally and in writing, and the consumer must acknowledge in writing that the disclosures were received. The final rule, which is effective October 1, 2001, implements Section 305 of the Gramm-Leach-Bliley Act. *PR-87-2000, FDIC, 12/4/00.*

CRA Sunshine Regulation

On December 21, 2000, the federal bank regulatory agencies approved a final regulation that governs how banks and community organizations disclose their community lending agreements. The rule implements the CRA Sunshine Requirements of the Federal Deposit Insurance Act, which were enacted by the Gramm-Leach-Bliley Act. The rule requires banks and thrifts to make available for public disclosure agreements they have with community groups and other organizations in connection with compliance under the Community Reinvestment Act. The rule also requires banks and thrifts to send copies of such agreements to the appropriate banking regulator. The rule, which was issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS), becomes effective April 1, 2001. *NR 2000-105, OCC, 12/21/00; BBR, 1/8/01, p. 9–10.*

Customer Information Security Guidelines

The federal bank and thrift regulatory agencies adopted guidelines for safeguarding confidential customer information. The purpose of the safeguards is to ensure the security and confidentiality of customer records and information. The guidelines implement Section 501(b) of the Gramm-Leach-Bliley Act and are effective July 1, 2001. The guidelines require financial institutions to establish an information security program to: (1) identify and assess the risks that may threaten customer information; (2) develop a written plan containing policies and procedures to manage and control these risks; (3) implement and

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Reference sources: American Banker (AB), Federal Register (FR), and BNA's Banking Report (BBR).

test the plan; and (4) adjust the plan on a continuing basis to account for changes in technology, the sensitivity of customer information, and internal or external threats to information security. The guidelines also outline responsibilities of directors of financial institutions in overseeing the protection of customer information. *OTS 01-04, OTS, 1/17/01.*

Debt Requirements for Banks that Own Financial Subsidiaries

On January 22, 2001, the Federal Reserve Board and the Treasury Department approved a final rule that sets the criteria that a specific class of national banks and state-member banks must meet to own financial subsidiaries. A national bank or a state-member bank wishing to control a financial subsidiary must rank as one of the 100 largest insured banks in the nation. The largest 50 banks in that group may control a financial subsidiary if their long-term debt receives a top investment-grade rating. The remaining 50 banks in the group also may control financial subsidiaries by meeting this long-term debt requirement or by meeting an alternative debt requirement, which is the focus of the final rule. The final rule allows the second group of 50 banks to meet the requirement if they have a current long-term issuer credit rating from a nationally recognized statistical rating organization that is within the three highest investment-grade categories used by the rating organization. In addition to the debt requirement, national and state-member banks must meet capital, management, and other requirements to operate financial subsidiaries. *BBR, 1/29/01, p. 131.*

Federal Deposit Insurance Corporation

Tanoue Resigns

On July 11, 2001, Donna Tanoue resigned from the FDIC, where she served as chairman since May 26, 1998. Under Ms. Tanoue's leadership, the FDIC conducted a review of the deposit-insurance system and proposed important changes to the federal deposit-insurance program. The Corporation also addressed the risk of subprime lending and initiated proposals to address the problems of predatory and payday lending. Before coming to the FDIC, Ms. Tanoue was a partner in the Hawaii law firm of Goodsill Anderson Quinn & Stifel. *PR-45-2001, FDIC, 6/12/01; BBR, 6/18/01, p. 1022.*

Board Member Appointed

John M. Reich was sworn in on January 16, 2001, to a six-year term as a Director on the FDIC's Board of Directors. Before joining the FDIC, Mr. Reich served for 12 years on the staff of U.S. Senator Connie Mack (R-FL), where he was the chief of staff from 1998 through 2000. Mr. Reich directed and oversaw all committee activity, including Senator Mack's activity on the Senate Banking Committee. Before working with Senator Mack, Mr. Reich spent 23 years in the banking business in Illinois and Florida. *AB, 12/19/00.*

Final Regulation on State Banks' Activities and Investments

The FDIC released a final regulation on December 21, 2001, governing how the agency approves activities and investments of insured state-chartered banks. The rule was required by the Gramm-Leach-Bliley Act (GLBA), which created a new Section 46 of the Federal Deposit Insurance Act. Section 46 outlines the FDIC's approval procedures for various activities of state nonmember banks. Before GLBA, approvals of state-bank activities were handled under Section 24 of the Federal Deposit Insurance Act. The final rule permits state banks to seek approval under either Section 24 or Section 46. In addition, the final rule grandfathers activities by a state bank that has already received approval under Section 24, if the Treasury Department and the Federal Reserve Board have not already made certain other determinations under Section 46. The final rule also eases the approval process by permitting banks to enter into a new activity as soon as the FDIC receives notice from the bank that it complies with all requirements for that activity. *BBR, 1/8/01, p. 15.*

Money Smart Program

The FDIC and the Department of Labor announced on January 1, 2001, a joint initiative called *Money Smart*, which offers basic financial education to people taking part in Welfare-to-Work and Workforce Investment Act programs nationwide. *Money Smart* consists of 10 training modules covering basic financial education topics. The program is designed to help adults currently outside the financial mainstream build financial knowledge and develop positive relationships with financial institutions. Beginning in the second quarter of 2001,

Money Smart will be available through a national network of more than 800 centers that provide employment and training services for persons seeking new jobs or entering the workforce, including individuals participating in Welfare-to-Work programs. *PR-6-2001, FDIC, 1/19/01.*

Report on Underwriting Practices

The October 2000 issue of the FDIC's semiannual *Report on Underwriting Practices* reported a slight increase in the occurrence of risky underwriting practices for construction, commercial (nonresidential) real-estate, and home-equity lending during the six-month period ending September 30, 2000. The risks associated with current underwriting practices, loan growth, and credit risk in banks' loan portfolios also increased during the six-month period. In contrast, the occurrence of risky underwriting practices for agriculture lending decreased. The survey of loan underwriting practices is aimed at providing early warnings of potential problems in underwriting practices at FDIC-supervised, state-chartered nonmember banks. The focus of the survey is threefold: material changes in underwriting standards for new loans, degree of risk in current practices, and specific aspects of the underwriting standards for new loans. The October report includes surveys from 1,124 FDIC-supervised banks that were examined during the six months ending September 30, 2000. *Report on Underwriting Practices, FDIC, October 2000.*

In the April 2001 issue of the *Report on Underwriting Practices*, the FDIC reported that the occurrence of risky underwriting practices by banks increased for both construction and consumer lending, but the risks associated with general underwriting practices decreased slightly. The April report summarizes responses from FDIC examiners to survey questions regarding the lending practices at 1,181 FDIC-supervised banks examined during the six-month period ending March 31, 2001. *Report on Underwriting Practices, FDIC, April 2001.*

Real-Estate Survey—July 2000

The July 2000 issue of the *Survey of Real Estate Trends* reported continued favorable views of local residential and commercial real-estate markets. Survey respondents were asked if general conditions for U.S. real-estate markets had changed (as characterized by vacancy rates, market prices, and the pace of sales) in the first six months of 2000. The percentage of respondents reporting no change was high across all property markets: single-family (58 percent), multifamily (72 percent), office (72 percent), retail (78 percent), and industrial (73 percent). Where general market conditions were reported to have changed, improving conditions were observed more often than worsening conditions. The July report summarized the opinions of 256 survey respondents, which consisted of FDIC senior examiners and asset managers as well as bank examiners of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. *Survey of Real Estate Trends, FDIC, July 2000.*

Real-Estate Survey—January 2001

The January 2001 issue of the *Survey of Real Estate Trends* reported that conditions generally remained favorable in the nation's real-estate markets during the second half of 2000, although there was some deterioration, particularly involving single-family homes and local retail properties. The percentage of respondents reporting no change in the condition of U.S. real-estate markets was high across all property markets: single-family (56 percent), multifamily (75 percent), office (69 percent), retail (75 percent), and industrial (76 percent). However, reports of slight deterioration in conditions were more frequent than those of improvement for all property markets except industrial. This development was in contrast to the first half of 2000 when reports of improving conditions outnumbered those of worsening ones. Single-family markets had the highest proportion of respondents noting somewhat worsening conditions—27 percent of respondents reported worsening conditions *versus* 17 percent reporting better conditions. Eighteen percent of respondents reported deterioration in local retail markets, while only 7 percent reported better conditions. The January report summarized the opinions of 265 survey respondents, which consisted of FDIC senior examiners and asset managers as well as bank examiners of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. *Survey of Real Estate Trends, FDIC, January 2001.*

Insurance Funds' Financial Results for 2000

The FDIC reported that the Bank Insurance Fund (BIF) experienced comprehensive income (net

income plus unrealized gains/losses on available-for-sale securities) of $1.6 billion for the 12 months ending December 31, 2000, compared to a loss of $198 million during 1999. At December 31, 2000, the BIF balance was approximately $31 billion, up from $29.4 billion at year-end 1999. The increase in income was primarily attributable to low estimated losses recognized on institutions that failed in 2000 and an increase in the market value on available-for-sale securities. BIF revenues totaled $1.9 billion in 2000, including $1.8 billion in interest on investments in U.S. Treasury obligations and $45 million in deposit insurance assessments. The Savings Association Insurance Fund (SAIF) reported comprehensive income of $478 million in 2000, compared to $441 million in 1999. The SAIF closed the year with a fund balance of $10.8 billion, an increase from $10.3 billion at year-end 1999. The SAIF earned $664 million in revenue during 2000, consisting of $644 million in interest on investments in U.S. Treasury obligations and $19 million in deposit insurance assessments. *PR-29-2001, FDIC, 4/10/01.*

Bank Failures

On September 29, 2000, Mississippi's Commissioner of Banking and Consumer Finance closed the Bank of Falkner, Falkner, Mississippi, and named the FDIC as receiver. The Bank of Falkner had total assets of approximately $88.8 million and deposits of $77.1 million in approximately 5,827 accounts. Citizens Bank & Savings Company, Russellville, Alabama, paid a premium of $2.5 million to purchase the failed institution's insured deposits and approximately $21.7 million of the assets. The FDIC retained the remaining assets for later disposition. The Bank of Falkner is the fourth failure of a BIF-insured institution in 2000. *PR-66-2000, FDIC, 9/29/00.*

Hawaii's Commissioner of Financial Institutions closed the Bank of Honolulu, Honolulu, Hawaii, on October 13, 2000, and the FDIC was named receiver. The failed institution had total assets of approximately $66.9 million and total deposits of $59.5 million in approximately 5,900 accounts. The Bank of the Orient, San Francisco, California, paid the FDIC a premium of $1 million to assume the failed bank's insured deposits and paid an additional premium of $855,000 to purchase approximately $52.2 million of the failed bank's assets. Additionally, the Bank of the Orient was given a 30-day exclusive purchase option on another $9.3 million of the failed bank's assets. The FDIC retained the remaining assets for later disposition. The FDIC estimates that the failure will cost the BIF approximately $2.5 million. The Bank of Honolulu is the fifth failure of a BIF-insured institution in 2000. *PR-70-2000, FDIC, 10/13/00.*

National State Bank, Metropolis, Illinois, was closed by the Office of the Comptroller of the Currency (OCC) on December 14, 2000, and the FDIC was appointed receiver. The OCC used its authority under the FDIC Improvement Act of 1991 (FDICIA) to close the bank when it discovered that the bank was critically undercapitalized—the bank's tangible equity capital was less than 2 percent of its total assets. Inadequate control of the credit and transaction risks associated with its merchant-processing activities involving the settlement of credit-card-sales transactions for merchants resulted in a high volume of losses, which depleted capital and threatened the bank's liquidity. The FDIC entered into an agreement with Banterra Bank, Marion, Illinois, to assume the insured deposits of the failed bank, which were approximately $67 million at the time of closing. Banterra Bank also paid the FDIC a premium of approximately $2 million for the right to purchase $23.7 million of the failed bank's assets. The FDIC retained the remaining assets of approximately $68 million for later disposition. This is the sixth failure of a BIF-insured institution in 2000, and the seventh failure of an institution insured by the FDIC in 2000. *PR-90-2000, FDIC, 12/14/00.*

On February 2, 2001, the Bank Commissioner for the state of New Hampshire closed First Alliance Bank & Trust Company, Manchester, New Hampshire, and the FDIC was named receiver. The failed bank had approximately $18.4 million in assets and $17.5 million in deposits. Southern New Hampshire Bank & Trust, Salem, New Hampshire, paid the FDIC a premium of $150,000 for the right to assume the deposits and to purchase $17.1 million of the failed bank's assets. The FDIC retained the remaining $1.3 million of assets for later disposition. The FDIC estimates this transaction will cost the BIF approximately $119,000. First Alliance is the first failure of a BIF-insured institution in 2001. *PR-11-2001, FDIC, 2/2/01.*

On May 3, 2001, the OCC closed The Malta National Bank, Malta, Ohio, and appointed the FDIC as receiver. The OCC used its statutory receivership authority to close the bank after finding

that the bank had engaged in unsafe-and-unsound practices and had incurred significant losses. The failed bank had total deposits of approximately $8.8 million and total assets of $9.5 million. The FDIC entered into an agreement with North Valley Bank, Zanesville, Ohio, to assume all of the failed bank's deposits. North Valley Bank also purchased $9.2 million of the failed bank's assets at a discount of approximately $800,000 from book value. The FDIC retained the remaining assets for later disposition. The FDIC estimates the transaction will cost the BIF approximately $80,000. This was the second failure of a BIF-insured institution in 2001. *PR-32-2001, FDIC, 5/3/01.*

Federal Reserve Board

Interest Rates

Between January 3, 2001, and June 27, 2001, the Federal Open Market Committee (FOMC) lowered the targeted federal funds rate by 275 basis points, decreasing the rate from 6.50 percent to 3.75 percent. The Board of Governors decreased the discount rate by 275 basis points during the same time period, lowering the rate from 6.00 percent to 3.25 percent. The federal funds rate is the fee that banks charge each other for overnight loans, and the discount rate is the fee charged to financial institutions for borrowing from their district Federal Reserve Banks. *PR-FRB, 1/3/01, 1/31/01, 3/20/01, 4/18/01, 5/15/01, 6/27/01.*

Regulation Z

The Federal Reserve Board adopted a final rule aimed at helping consumers decipher credit-card companies' marketing pitches about interest rates, late fees, grace periods, and other terms. The rule amends Regulation Z, which implements the Truth in Lending Act, to revise the disclosure requirements for credit-card solicitations and applications. Under the new rule, credit-card issuers will have to include an easy-to-read chart on all credit-card solicitations and applications, laying out in simple terms the interest rate consumers will pay to carry debt on the card. The rule comes in response to rising concern among bank regulators about overly aggressive marketing tactics by credit-card issuers that can confuse consumers and make credit-card purchases more expensive than anticipated. The rule is effective September 27, 2000, and compliance is mandatory as of October 1, 2001. *The Washington Post, 9/29/00; FR, 10/3/00.*

Assessment of Foreign Banks' U.S. Operations

On October 24, 2000, the Federal Reserve announced a series of steps to update its five-year-old system of supervising foreign banking organizations that operate in the United States. The Federal Reserve plans to improve its "Strength of Support Assessment" (SOSA) process, through which it ranks foreign banks' ability to offer financial, liquidity, and management support to its American operations. The rankings help provide a point of reference for U.S. bank supervisors to assess the risks of a foreign bank's operations in the United States. Under the new system, the five current SOSA rankings will be streamlined into three rankings. The new initiative provides that the Federal Reserve will inform foreign banking organizations, as well as the banks' home-country supervisors, of the SOSA rankings. In addition, the new initiative calls for the creation of a combined assessment rating for all of a foreign banking organization's U.S. branches, agencies, and commercial lending companies. *BBR, 10/30/00, p. 545.*

New Annual Reserve and Reporting Requirements

On November 21, 2000, the Federal Reserve Board published in the Federal Register annual adjustments used to calculate reserve requirements and reporting requirements for depository institutions. The reserve requirements determine how much depository institutions must keep on hand either in cash, deposits at Federal Reserve Banks, or pass-through accounts at correspondent institutions. For the year 2001, the first $5.5 million in net transaction accounts will be exempt from the reserve requirements. Amounts between $5.5 million and $42.8 million will be subject to a 3 percent requirement, and amounts above $42.8 million are subject to a 10 percent reserve requirement. Effective September 2001, institutions must file reports on their deposit levels on a weekly, quarterly, or annual basis, depending on their deposit levels and their classification with respect to reserve requirements. However, U.S. branches and agencies of foreign banks must file deposit reports weekly, regardless of their size. *BBR, 11/27/00, p. 681.*

Financial Holding Companies Permitted to Offer Finder Services

On December 13, 2000, the Federal Reserve

Board approved a rule defining "finder" activities as financial in nature and therefore within the bounds of banks' legitimate business functions. A "finder" acts as an intermediary in a transaction that is negotiated between the buyer and seller, and facilitates the identification of the potential buyers and sellers. The rule, which amends Subpart I of Regulation Y, requires banks acting as finders to differentiate clearly between products and services they offer directly and those that are offered by third parties. Under the rule, financial holding companies acting as a finder can: identify third parties that may be interested in engaging in a transaction between themselves; ask third parties about their interest in engaging in a transaction with another party; introduce and refer potential parties to each other; arrange contacts and meetings between interested parties; and transmit information concerning products and services to potential parties in connection with the above activities. *BBR, 12/18/00, p. 783.*

Disclosure of ATM Fees

The Federal Reserve Board published a final rule amending Regulation E (Electronic Fund Transfers) to implement provisions of the Gramm-Leach-Bliley Act requiring disclosure of automated-teller machine (ATM) fees. Under the final rule, an ATM operator who imposes a fee on a consumer for an electronic-fund-transfer service is required to provide notice of the fee in a prominent and conspicuous location on or at the ATM where the electronic service is initiated. The ATM operator also must disclose the amount of the fee either on the screen of the ATM or on a paper notice before the consumer is committed to completing the transaction. A fee may not be imposed unless proper notice is provided and the consumer chooses to complete the transaction. The rule is effective March 1, 2001, and compliance with the rule is mandatory as of October 1, 2001. *PR-FRB, 3/1/01.*

HMDA Reporting Exemption Threshold Increased

The Federal Reserve Board raised the asset-size exemption threshold from $30 million to $31 million for depository institutions that are required to report data under the Home Mortgage Disclosure Act (HMDA). In 2001, depository institutions with assets of $31 million or less will be exempt from reporting data on their housing-related lending activities. The final rule amends Regulation C, which implements the Home Mortgage Disclosure Act. The asset level that releases institutions from reporting data under HMDA is adjusted each year on the basis of changes in inflation as measured by the Consumer Price Index for Urban Wage Earners and Clerical Workers. *NR 2001-10, OCC, 2/20/01.*

Daylight Overdrafts

On May 30, 2001, the Federal Reserve issued an interim rule permitting banks to accumulate negative balances in their accounts with the Federal Reserve during the course of the business day. The regulation, which is effective upon issuance, allows banks to seek "daylight credit" above their normal overdraft caps. The action reflects ongoing efforts by the Federal Reserve Board to balance the costs, risks, and benefits associated with the provision of Federal Reserve intraday credits. *Dow Jones Newswires, 5/31/01.*

Survey on Bank Lending Practices

In its May 2001 *Senior Loan Officer Opinion Survey on Bank Lending Practices*, the Federal Reserve Board reported that both domestic and foreign banks were continuing a trend of stricter business lending practices. Slightly more than 50 percent of domestic banks reported tightened standards for commercial and industrial (C&I) loans to large and middle-market firms since the last survey in January 2001. About 36 percent of domestic banks tightened standards on loans to small firms over the same period. Both foreign and domestic institutions indicated that the most important reasons for tightening standards and terms on C&I loans were a less favorable economic outlook and a worsening of industry-specific problems. For the report, the Federal Reserve surveyed loan officers from 55 large domestic banks and 21 U.S. branches and agencies of foreign banks. The survey focused on changes during the preceding three months in the supply and demand for bank loans to households and businesses. *Senior Loan Officer Opinion Survey on Bank Lending Practices, FRB, May 2001.*

Office of the Comptroller of the Currency

Fees for Third-Party Exams

A rule issued on May 8, 2001, permits the OCC to charge for special examinations of banks' third-party service providers. Some banks recently have entered

new lines of business, or introduced potentially high-risk products, relying substantially on third-party service providers to enable the bank to conduct the activities. Since banks involved in such activities may be exposed to higher-than-normal levels of risk, examiners have an increased need to examine the third-party providers. The new rule, which becomes effective June 7, 2001, applies to a wide range of activities, including credit-card issuing, subprime lending, and check cashing. Before the rule, the OCC was permitted to assess a fee for a special examination of a bank, but not for special examinations of a third-party provider. *AB, 5/9/01.*

Pilot Program to Enhance National Banks' Lending Capacity

The OCC announced on June 8, 2001, a three-year pilot program intended to reduce the competitive disparity that exists in states that have single-borrower lending limits that are higher than the federal limits available to national banks. National banks are generally permitted to lend no more than 15 percent of their capital on an unsecured basis to a single borrower; however, many states have higher limits for their state-chartered institutions. The pilot program will allow national banks with the highest supervisory ratings to lend up to the state limit—but not more than 25 percent of capital—to single borrowers for small-business loans and for loans secured by single-family-residential real estate. Because the program is aimed primarily at community banks, only banks with assets of less than $1 billion are able to participate. To participate in the program, a bank must be rated 1 or 2 under the five-point Uniform Financial Institutions Rating System scale, which evaluates an institution's capital adequacy, asset quality, management capability, earnings strength, liquidity, and sensitivity to market risk. Eligible banks must also have a rating of at least 2 for the asset and management components of the test. *NR 2001-52, OCC, 6/8/01.*

Survey of Credit Underwriting Practices

The OCC's annual *Survey of Credit Underwriting Practices* reported that underwriting standards for commercial and retail loans tightened during the 12-month period ending March 31, 2001. Fifty-five percent of banks tightened commercial loan standards in 2001, compared to 25 percent in 2000; 6 percent loosened standards in 2001, compared to 16 percent in 2000. The survey found that 32 percent of banks tightened underwriting standards for retail loans, while 20 percent eased standards. The 2001 survey covered the 66 largest national banks with an aggregate loan portfolio of $2 trillion—approximately 90 percent of national bank loans. The survey, which is completed by OCC senior examiners, consists of a series of questions concerning 16 types of commercial and retail lending. The questions focus on the direction of lending standards and the level of inherent risk in the portfolio and products of the banks. *NR 2001-59, OCC, 6/27/01.*

Office of Thrift Supervision

Seidman Offers Resignation

On July 3, 2001, Ellen Seidman announced that she submitted her resignation as the Director of the Office of Thrift Supervision (OTS). Her resignation is effective upon the confirmation and appointment of a replacement. Ms. Seidman has served as the Director of the OTS since October 27, 1997. Before becoming director, Ms. Seidman was a Special Assistant to President Clinton for Economic Policy at the White House National Economic Council. *OTS 01-43, OTS, 7/3/01.*

Liquidity Requirements

The OTS issued a final rule that removes the regulation requiring savings institutions to maintain an average daily balance of liquid assets of at least 4 percent of their liquidity base. The final rule requires thrifts to maintain adequate liquidity to ensure safe-and-sound operation. The rule, which is effective July 18, 2001, will give thrifts greater flexibility in adjusting their asset mix. *BBR, 3/19/01, p. 478; FR, 7/18/01.*

Federal Housing Finance Board

Chairman Appointed

President Bush designated J. Timothy O'Neill Chairman of the Federal Housing Finance Board on June 18, 2001. Mr. O'Neill has served as a director of the Finance Board since June 1995. Before joining the Finance Board, Mr. O'Neill was a partner in the Washington, D.C., law firm of O'Connor & Hannan, where he focused on trade and international law and legislative and regulatory issues. Mr. O'Neill was also Director of Congressional Affairs at the Finance Board in 1991 and 1992. *FHFB 01-13, FHFB, 6/19/01.*

Board Member Appointed

On December 28, 2000, President Clinton announced the recess appointment of Allan I. Mendelowitz to serve as a member of the Board of Directors for the Federal Housing Finance Board. Mr. Mendelowitz served as Chairman of the Board from December 28, 2000, until June 18, 2001, when President Bush appointed J. Timothy O'Neill as chairman. Mr. Mendelowitz served as the executive director of the U.S. Trade Deficit Review Commission from October 1999 to December 2000. From January 1999 to September 1999, he was vice president of the Economic Strategy Institution, where he supervised research on trade policy, international competitiveness, and telecommunications policy. *FHFB 00-41, FHFB, 12/28/00.*

Collateral Rules Eased

The Federal Housing Finance Board (FHFB) announced on November 30, 2000, that four regional Home Loan Banks expanded the type of loans small member banks can pledge as collateral for advances. Member banks typically have used mortgages as collateral for advances, but the Dallas, Topeka, Des Moines, and Seattle Home Loan Banks will now permit member institutions with assets less than $500 million to use small-business, farm, and agriculture-business loans as collateral. The FHFB will permit the other Home Loan Banks to adopt similar plans at any time. *AB, 12/1/00.*

Final Rule on Capital Standards

The Federal Housing Finance Board approved a final rule on December 20, 2000, implementing a new capital structure for the Federal Home Loan Banks. The final rule replaces the FHLBanks' subscription capital structure with a more flexible, risk-based capital structure, and the rule contains risk-based and leverage-capital requirements similar to those for depository institutions. The final rule implements provisions of the Gramm-Leach-Bliley Act (GLBA) that establish two classes of capital stock: Class A, which is redeemable on six months' notice; and Class B, which is redeemable on five years' notice. The rule also incorporates the requirements that each FHLBank maintain a minimum ratio of total capital to total assets of at least 5 percent and that a FHLBank may not redeem stock if it would fail to meet any of its minimum capital requirements. Each FHLBank may weight its permanent capital at 1.5 times paid-in value to meet the 5-percent test, as long as its total capital, excluding such weighting, is not less than 4 percent of its total assets. Each FHLBank also must have enough permanent capital to meet the rule's risk-based capital requirements for credit risk, market risk, and operations risk. GLBA requires each of the FHLBanks to submit a capital structure plan to the Finance Board for approval within 270 days of the publication of the final rule and provides for a transition period to the new capital structure of up to three years from the effective date of each FHLBank's capital structure plan. *FHFB 00-38, FHFB, 12/20/00.*

Amendment to Affordable Housing Program

On May 4, 2001, the Federal Housing Finance Board approved a rule amending its Affordable Housing Program (AHP) regulations to improve the program's effectiveness and efficiency. The most significant rule change increases the maximum amount of money that can be set aside annually under a Federal Home Loan Bank's homeownership set-aside program to the greater of $3 million or 25 percent of a FHLBank's annual AHP contribution. Those limits previously were the greater of $1.5 million or 15 percent of the FHLBank's annual AHP contribution. Each FHLBank independently operates an Affordable Housing Program in accordance with the FHLBank Act. Funding for each program varies by FHLBank, but banks must set aside a minimum of 10 percent of their funding for affordable housing initiatives. *FHFB 01-10, FHFB, 5/4/01; BBR, 5/14/01, p. 858.*

National Credit Union Administration

Acting Chairman Appointed

On February 8, 2001, President Bush named Dennis Dollar Acting Chairman of the NCUA Board of Directors. Mr. Dollar has been a member of the Board since October 1997. His current term expires on August 2, 2001. Before joining the NCUA, Mr. Dollar served as CEO of the Gulfport VA Federal Credit Union from 1992 to 1997. Mr. Dollar also served two terms in the Mississippi House of Representatives from 1975 to 1983. *PR020901, NCUA, 02/09/01.*

Board Member Appointed

President Clinton named Geoff Bacino to the NCUA Board of Directors in a recess appointment effective December 29, 2000. Mr. Bacino, who was originally nominated for a seat on the Board on July 24, 2000, fills the seat held by Chairman Norman E. D'Amours whose term expired August 2, 1999. Mr. Bacino was president of Bacino and Associates, a lobbying and public-relations firm in Alexandria, Virginia. He previously served as a lobbyist for the Credit Union National Association, co-founded the National Association of State-Chartered Credit Unions, and served as executive director of the National Association of Share Insurance Corporations. *PR010201, NCUA, 01/02/01.*

Credit Unions Receive Dividend

On March 8, 2001, the NCUA voted to waive an insurance premium for 2001 and pay a dividend of $99.5 million to the nation's federally insured credit unions. The average size $48-million credit union will receive a dividend of approximately $11,000. The dividend returns the National Credit Union Share Insurance Fund (NCUSIF) to the normal operating level of 1.3 percent of deposits of federally insured credit unions. Since the NCUSIF was recapitalized in 1985, approximately $552 million has been returned to federally insured credit unions in the form of dividends. *PR030801, NCUA, 3/8/01.*

STATE LEGISLATION AND REGULATION

Illinois

Chicago became the first city to take local legislative action against predatory lending by passing an ordinance on August 30, 2000, that prohibits financial institutions engaged in predatory practices from acting as city depositories or contractors. The "Anti-Predatory Lending Ordinance" defines "predatory" as any loan with an annual percentage rate that exceeds the U.S. Treasury rate by more than six percentage points. The ordinance requires all city depositories and financial-services vendors to pledge that neither they nor their affiliates will engage in predatory lending. Institutions that fail to sign the pledge will be barred from city contracts. Mayor Richard Daley introduced the ordinance in an effort to curb lending practices that have contributed to unprecedented rates of foreclosures and abandonment of single-family residences in the city. *BBR, 9/11/00, p. 319–320.*

On April 17, 2001, the Illinois Joint Committee on Administrative Rules adopted regulations aimed at preventing predatory lending in Illinois. The regulations apply to high-risk loans, which are defined as: first-mortgage loans with an annual percentage rate of at least 6 percent more than the U.S. Treasury securities rate, and second-mortgage loans with an annual percentage rate of at least 8 percent greater than the U.S. Treasury securities rate. The regulations also apply to loans with total points and fees exceeding $800 or 5 percent of the total loan, whichever is greater. When such high-risk loans are issued, lenders are required to verify the borrower's ability to repay and are restricted from tacking single-premium credit life insurance onto the loan. The regulations impose several other restrictions on Illinois-licensed lenders, including: a prohibition on deceptive marketing and sales techniques; a ban on loan flipping; a ban on negative amortization of loans; limits on the financing of points and fees; limitations on balloon payments; and prohibitions on loans in which payments are made solely to a contractor. *BBR, 4/9/01, p. 631.*

New York

Governor George E. Pataki (R) signed a bill on September 8, 2000, that extends New York state's "wild card" banking law for another three years. The law will now expire September 10, 2003. The "wild card" legislation gives the New York State Banking Department the ability to grant state-chartered banks powers matching those powers enjoyed by federally chartered banks. The legislation is necessary to protect the viability of New York state's banking charter and New York's banking consumers. In addition to extending the expiration date, the new law strengthens consumer protection provisions by prohibiting banks from charging customers certain fees solely because the customer purchases insurance from an insurer other than the bank or one of its affiliates. *BBR, 9/25/00, p. 389.*

On November 9, 2000, the New York State Insurance Department issued a rule for safeguarding

consumers' confidential personal information. All licensed insurers are required to provide initial notice to consumers of how they share nonpublic personal financial information with unaffiliated parties, and they must provide an annual opportunity for consumers to "opt out" of having their information shared with third parties. The rule brings New York insurers into compliance with the privacy requirements of the Gramm-Leach-Bliley Act. *AB, 11/13/00.*

Pennsylvania

The Philadelphia City Council passed an ordinance on April 5, 2001, banning predatory lending in the city and requiring loan counseling for borrowers who were charged high interest rates. The city is targeting nonbank lenders, however, and the ordinance exempts state and national banks and thrifts and trust companies. The ordinance prohibits lenders from making high-cost loans. A high-cost loan is defined as one with an interest rate more than 6.5 percentage points above the U.S. Treasury securities rate, and with total points and fees financed equal to four percentage points of the loan amount. Lenders found to be predatory will be fined and will lose all contracts with the city or city agencies. The ordinance also establishes a Predatory Lending Review Committee to investigate allegations of abusive lending and to help the victims of predatory lenders. *AB, 4/6/01.*

BANK AND THRIFT PERFORMANCE

Fourth-Quarter 2000 Results for Commercial Banks and Savings Institutions

FDIC-insured commercial banks earned $17.8 billion during the fourth quarter of 2000, which is $1.5 billion less than third-quarter earnings, but $91 million more than earnings in the fourth quarter of 1999. Banks' annualized return on assets (ROA) was 1.16 percent in the fourth quarter, down from 1.28 percent in the third quarter and 1.27 percent one year earlier. The number of commercial banks on the FDIC's "Problem List" increased from 75 to 76 banks during the quarter, while assets of problem banks increased from $14 billion to $17 billion. There were two commercial bank failures in the fourth quarter of 2000.

FDIC BIF-insured mutual savings institutions reported earnings of $2.6 billion in the fourth quarter of 2000, up $49 million from the third quarter, but $90 million less than earnings one year earlier. The industry's ROA for the fourth quarter held steady from the third quarter at 0.86 percent, but was down from 0.95 percent in the fourth quarter of 1999. The number of problem thrifts increased to 18 thrifts from 15 in the third quarter, but assets of problem thrifts decreased from $7.3 billion in the third quarter to $7.1 billion at year-end 2000. There were no thrift failures during the fourth quarter of 2000. *FDIC Quarterly Banking Profile, Fourth Quarter 2000.*

First-Quarter 2001 Results for Commercial Banks and Savings Institutions

FDIC-insured commercial bank earnings rebounded in the first quarter of 2001—net income totaled $19.9 billion in the quarter, up $2.1 billion from the previous quarter and $400 million higher than earnings in the first quarter of 2000. Commercial banks' average ROA was 1.27 percent in the first quarter of 2001, up from 1.16 percent in the fourth quarter of 2000, but down from 1.35 percent in the first quarter of 2000. The number of commercial banks on the FDIC's "Problem List" increased from 76 to 78 banks during the quarter, but assets of problem banks remained unchanged at $17 billion. There was one bank failure during the first quarter.

FDIC BIF-insured mutual savings institutions reported earnings of $2.9 billion in the three months from January through March 2001, which is $300 million higher than the previous quarter but $35 million lower than one year earlier. The industry's ROA for the first quarter was 0.95 percent, up from 0.86 percent in the fourth quarter of 2000, but down from 1.03 percent one year earlier. The number of problem thrifts declined from 18 to 17 during the quarter, and problem assets decreased from $7.1 billion to $6.1 billion. There were no thrift failures during the first quarter of 2001. *FDIC Quarterly Banking Profile, First Quarter 2001.*

RECENT ARTICLES AND STUDIES

A report released by the OCC on October 27, 2000, says that the number of national banks offering online financial services on Internet sites increased by 52 percent from September 1999 to July 2000. The percentage of national banks allowing customers to transact business on their Web sites

increased from 21 percent in September 1999 to 32 percent in July 2000. In addition, although smaller national banks (banks with less than $100 million in assets) still lag behind larger banks, the percentage of small banks offering transactional Internet services increased from 7 percent to 17 percent during the period studied. *BBR, 11/6/00, p. 587.*

An October 2000 report by the Federal Reserve Bank of Cleveland suggests a merger of the two federal deposit insurance funds would reduce costs to taxpayers and would not present a risk to the financial-services industry. James B. Thompson, an economist at the Federal Reserve, reports that financial market integration has effectively removed economic distinctions between depository institutions and the risks they face, making it difficult to argue that banks and savings associations operate in distinct markets with widely different types of risk exposure. The author points out that nearly one-half of bank loans are related to real estate and that more than 12 percent of loans made by thrifts are consumer loans or commercial and industrial loans. In addition, almost 40 percent of SAIF-insured deposits originate with commercial banks, while savings association deposits make up 9 percent of BIF accounts. The report, entitled "Two Deposit Insurance Funds Are Not Necessarily Better Than One," was published in the Federal Reserve Bank of Cleveland's *Economic Commentary*. *BBR, 1/16/01, p. 57–58.*

On April 25, 2001, the Bank for International Settlements issued a report on the role of stress testing in financial institutions' risk-management activities. The report, entitled *A Survey of Stress Tests and Current Practice at Major Financial Institutions*, was prepared by a task force formed under the Committee on the Global Financial System (CGFS) of the central banks of the Group of Ten countries. In early 2000, the CGFS conducted a survey of stress-testing scenarios used at 43 major financial institutions, including both commercial and investment banks, in ten countries. The survey results implied that stress testing has become an integral part of banks' risk-management practices. *BBR, 4/30/01, p. 768–769.*

INTERNATIONAL DEVELOPMENTS

Basel Committee

The Basel Committee on Banking Supervision on September 14, 2000, issued revised guidelines on credit risk in banking. The guidelines were introduced by the Basel Committee initially in July 1999, but have been slightly altered in order to reflect comments made from industry representatives. The guidelines set out 17 principles for assessing banks' management of credit risk, covering areas such as: establishing an appropriate credit-risk environment, operating under a sound credit-granting process, maintaining an appropriate credit administration, ensuring adequate controls over credit risk, and spelling out the role of supervisors in overseeing bank credit-risk-management efforts. The guidelines are contained in two papers, entitled *Principles for the Management of Credit Risk* and *Best Practices for Credit Risk Disclosure*. *PR-FRB, 9/14/00; BBR, 9/18/00, p. 375.*

Wolfsberg Anti-Money Laundering Principles

On October 30, 2000, a multinational coalition of 11 private banks announced a set of voluntary guidelines aimed at curbing money laundering. The guidelines call for bank officials to exercise due diligence when opening accounts or performing transactions for customers by collecting and recording specific information regarding the identities of account-holders and the sources of their funds. Specifically, the guidelines state that the banks should collect hard data on the following: the purpose and reasons for opening a bank account; anticipated account activity; the source of wealth; the source of funds; the estimated account net worth; and references or other sources to corroborate reputation information. The banks agreeing to the guidelines are ABN AMRO Bank, Barclays Bank, Banco Santander Central Hispano, S.A., Chase Manhattan Private Bank, Citibank, N.A., Credit Suisse Group, Deutsche Bank AG, HSBC, J.P. Morgan, Societe Generale, and UBS AG. *BBR, 11/6/00, p. 581.*