CHAPTER 8 – OTHER SIGNIFICANT ISSUES

During the bank and thrift crisis that began in 1980, the Federal Deposit Insurance Corporation (FDIC) resolved many institutions under widely different circumstances. The FDIC learned many valuable lessons from these experiences. In response to changes in the banking industry as well as legislative changes, the FDIC has adopted a number of revisions changes in the strategies used to market and sell the assets and liabilities of failing banks and thrifts since the early 1980s. While the techniques have evolved over time, the FDIC's primary resolution considerations remain, conducting the least cost resolution and quickly selling as many assets as possible to the private sector.

Maintaining Public Confidence in the Banking System

One of the FDIC's primary missions is to maintain public confidence in the U.S. financial system. When a bank fails, the FDIC accomplishes this by ensuring the prompt and efficient payment to customers with insured deposits, by minimizing the impact of an institution failure on the local economy, by finding an assuming or agent institution to handle insured deposits, and by transferring as many of the failed bank or thrift's assets as possible back into the private sector.

Adequacy of Insurance Funds

To efficiently resolve a banking crisis, it is critical to have an adequate insurance fund reserve. If such funds are not available, the problems may become worse as a result of delay. As the Federal Savings and Loan Insurance Corporation (FSLIC) began to experience a greater outflow of funds than it had coming in, it took steps to conserve cash. Although many of its programs were designed to give failing institutions time to work out their problems, some programs had the unintended effect of postponing the problems and actually increasing resolution costs. The FSLIC lacked the financial liquidity to promptly close insolvent institutions, and many of them remained open to compete with healthy institutions. In addition, several state-run insurance funds folded in the 1980s and the 1990s due to liquidity problems and inadequate insurance funds to protect the depositors in their states.

Other Resolution Concerns

Expeditious Resolutions

Experience suggests that failing financial institutions should be resolved as quickly as possible. Asset and franchise values are preserved and maximized, making them more desirable to healthy institutions. Normally, the more quickly an institution is resolved, the lower the cost. Finally, failing financial institutions can have negative effects on the markets in which they compete, and their quick exit from those markets minimizes those effects.

A problem situation should be dealt with immediately. This is an important lesson from the savings and loan crisis. The FSLIC's lack of funds to fully resolve the crisis and the relaxation of accounting and regulatory standards which was intended to give the problems time to correct themselves, only made the situation worse.

Bidders' Qualifications

It has always been the FDIC's practice to offer a failing institution to both operating financial institutions and investors who qualify for and have been given conditional approval for a charter to create a new institution (called a *de novo* institution). However, the application process may be difficult to complete within the timeframes required for resolving failing institutions. Although *de novo* charters are granted by the various chartering authorities, the FDIC must also approve the application so that the new institution's deposits can be insured. Currently, all states and federal chartering authorities require FDIC insurance as a condition for granting a new charter.

Bidders' Due Diligence

A concern that arises during the bidders' due diligence is the fair and equitable treatment of all due diligence participants. Bidders should be given as much time as possible to perform their reviews, while keeping in mind the time constraints of the resolution process. If information is revealed late in the due diligence process, all bidders who have already completed their reviews must be contacted and apprised of the additional information. If more than one potential purchaser must be scheduled to perform due diligence during the same time period (because of bank size limitations or time constraints), it is important to have identical sets of information for each group.

Choosing the Appropriate Resolution Structure

There is no one right way to resolve a failing institution. The method must be chosen to fit the situation at hand. Choosing the appropriate resolution structures can ease the economic dislocation of financial institution failures. Examples of economic dislocations that disrupt orderly economic activity in an industry or region may include: the loss of a local institution in an isolated area, a severe reduction in available credit for an industry or region, and massive government ownership of a failed institution's assets. Transactions that tend to lessen economic dislocations are those that maximize private ownership of assets, preserve franchise values, minimize the time that assets are under FDIC control, and preserve competitive markets.

A resolution process that most closely resembles a free market should yield the best economic results for all involved. Such a process maximizes the number of bidders, allows for a wide variety of transaction structures, provides as good information as is available, and provides as much time as possible for due diligence.

Resolution Timeframes

Resolution structures that involve working with an acquirer over a period of time must be carefully crafted to provide appropriate incentives for acquiring institutions. For example, loss sharing transactions have been successful because they align the economic interests of the asset purchasers with those of the FDIC.

Receivership Issues

Working with the Local Media

Assistance can be gained and goodwill can be created by sharing with the local media as much information as possible about the resolution. Announcements through television, radio, and the local newspapers should provide failed institution customers with information about how the resolution will be handled. For some institutions, especially those in small towns or where there has not been a closing for some time, it can be beneficial to conduct a town meeting to answer questions about the failure, the resolution process, the closing process, the transfer of insured deposit accounts, and other general questions.

Occasionally, reporters have asked to observe the FDIC as it goes through a resolution and closing process. These reporters are required to sign confidentiality agreements regarding any institution- or borrower-specific information they might see. Although the FDIC does not seek this coverage, every attempt is made to accommodate reporters' requests. It is beneficial to have knowledgeable, experienced reporters familiar with the resolution and closing process, because these reporters can be especially helpful in keeping the public informed.

Closing Matters

When planning for any closing, whether there is to be an acquiring institution or not, it is important to make arrangements for direct deposits coming into the failing bank or thrift.[1] These direct deposits should be routed to another institution so that depositor cash flows are not interrupted. If arrangements for direct deposits are not made, incoming deposits will be returned to the senders, and it can take months for depositors to get their funds.

Another closing issue is automated teller machines (ATM). On-line debit servicers (for example, Cirrus, Bank Plus, and Versatel) must be contacted so that withdrawals from failed institution accounts are not permitted unless the accounts are transferred to an acquiring or agent institution. Additionally, deposits in ATMs on the day of closing must be collected and posted as of the last day of business.

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[1] Direct deposits are funds automatically deposited to a customer's account using electronic fund transfers. These payments are usually repetitive and are normally periodic, such as weekly, monthly, or quarterly. Examples of direct deposits might include paychecks, government assistance payments, and pension payments.

If the failed institution's closing results in a straight deposit payoff, whether by mail or at the failed institution, it is necessary to consider two important things:

- Large numbers of customers may come to the institution, either to collect their checks that represent the insured portion of their deposits or to discuss their accounts. Long lines may form at the institution's doors many hours before the scheduled opening time if customers fear the insurer will run out of money.

- Customers with uninsured deposits may be confused about the amounts of their insurance checks and will need personal attention from claims agents. Confidential conference rooms should be set up where these customers can have private discussions. It is also necessary to counsel customers with uninsured deposits about how to file claims on the uninsured potion of their deposit.

Value of Assets in Receivership

Assets not sold to acquirers at resolution should be given prompt attention. Assets that are not loans, such as automobiles and furniture, should be sold or otherwise converted to cash as quickly as possible. Loan assets need special handling. It is essential to establish procedures for receivership representatives to work with those who had loans with the failed institution. These borrowers will need to establish new banking relationships with healthy financial institutions that can address their on-going credit needs. One of a receiver's main goals should be to assist borrowers in establishing these new credit relationships.

However, not all borrowers can be refinanced. The receiver should decide if more can be recovered through sale of the asset than through other liquidation means. Assets that should be sold need to be sold quickly, so they retain their value.

Restructuring a loan for a financially distressed borrower is normally more productive for the receiver than foreclosing on the collateral or initiating lawsuits to collect the debt. Maximizing recovery on failed institution assets is the receiver's responsibility, and litigation expenses can very rapidly consume any funds recovered.

It is important to note that when liquidating a failed institution's loans, on-going businesses that are borrowers need to continue to operate. The receiver must consider the repayment sources of loans when in determining a liquidation strategy. For example, if a small business loan is secured by all of the furniture and equipment in its office or factory, but repayment comes from on-going business activity, then it would not be prudent on the part of the receiver to foreclose on the furniture and equipment. This would put the firm out of business and eliminate any further sources of repayment.