CHAPTER 3 – PURCHASE AND ASSUMPTION TRANSACTIONS

Historically, the Federal Deposit Insurance Corporation (FDIC) has used three basic resolution methods: purchase and assumption (P&A) transactions, deposit payoffs, and open bank assistance (OBA) transactions. Of the three, purchase and assumption transactions are the most common.

Structure of a Purchase and Assumption Transaction

A P&A is a resolution transaction in which a healthy institution *purchases* some or all of the assets of a failed bank or thrift and *assumes* some or all of the liabilities, including all insured deposits. P&As are less disruptive to communities than payoffs. There are many variations of P&A transactions; two of the more specialized P&As are loss sharing transactions and bridge banks. Each type of P&A, including loss sharing and bridge banks, are discussed separately on the following pages.

In a P&A, the liabilities assumed by the acquirer include all or some of the deposit liabilities and secured liabilities, for example, deposit accounts secured by U.S. Treasury issues and repurchase agreements.[1] The assets acquired vary depending on the type of P&A. Some of the assets, typically loans, are purchased outright at the bank or thrift closing by the assuming bank under the terms of the P&A. Other assets of the failed institution may be subject to an exclusive purchase option by the assuming institution for a period of 30, 60, or 90 days after the bank or thrift closing.[2]

Some categories of assets *never* pass to the acquirer in a P&A; they remain with the receiver. These include claims against former directors and officers, claims under bankers blanket bonds and director and officer insurance policies, prepaid assessments, and tax receivables. Subsidiaries and owned real estate (except institution premises) pass infrequently to the acquirer in P&A transactions. Additionally, a standard P&A provision allows the assuming institution to require the receiver to repurchase any acquired loan that has forged or stolen instruments.

Before the banking crisis of the 1980s, the price paid by the assuming institution for assets other than cash was based on the value at which the assets were shown on the failing institution's books. Because asset values are generally overstated in a failing bank or thrift, the FDIC's ability to sell

---

[1] Repurchase agreements, also known as "repos," are agreements between a seller and a buyer whereby the seller agrees to repurchase securities, usually of U.S. Government securities, at an agreed upon price and, usually, at a stated time. When a bank uses a repo as a short-term investment, it borrows money from an investor, typically a corporation with excess cash, to finance its inventory using the securities as collateral. Repos may have a fixed maturity date or may be "open," meaning that they are callable at any time.

[2] These assets include premises owned by the failed institution, some categories of loans, rights to an assignment of leases for leased premises, data processing equipment, and other contractual services.

assets to an acquiring institution based on book value was limited. As the number of failures increased and liquidity and workload pressures grew, the FDIC began to base the purchase price of assets on their value as established by an asset valuation review performed by FDIC staff.

Until the late 1980s, it was common for an acquiring institution to bid on and purchase a failing institution without performing any review (also known as due diligence) of the failing institution's books and records, especially the loan portfolio. An acquirer was not even selected before the institution was closed. There were two reasons for this. First, the FDIC wanted to maintain secrecy about impending failures to avoid costly deposit runs; it was concerned that allowing due diligence teams access to a failing bank's premises would arouse fears about an imminent closing. The second reason was that, in the vast majority of transactions, only assets such as cash and cash equivalents[3] were passed to the acquirer, or assets were passed with a put option (discussed later in this chapter). In these circumstances, franchise bidders[4] did not require on-site due diligence. Bidders determined the potential value of the bank based on their knowledge of the local community and upon deposit information provided by examiners.

In a P&A transaction, acquirers may assume *all* deposits, thereby providing 100 percent protection to all depositors.[5] In contrast, in a deposit payoff the FDIC does not cover the portion of a customer's deposits that exceeds the insured limit.[6] In the two decades prior to the 1980s, most failing banks were resolved through P&As which passed all deposits to the acquiring institution. Critics observed that customers with uninsured deposits in large failed banks were less likely to suffer losses than those in small banks because the FDIC preferred to arrange P&A transactions to resolve large failures and because there was usually more market interest in large institutions. The increased market interest for larger institutions resulted in higher bids and smaller losses to the FDIC. The result was that customers with uninsured deposits rarely suffered losses in P&A transactions, and the FDIC essentially provided unlimited insurance coverage to the depositors. This subjected the FDIC to criticism that its resolution policies were inconsistent and inequitable, since smaller banks were more likely to be paid off.

Critics also indicated that when depositors had no fear that the uninsured portion of their deposits would be forfeited at a failure and others (for example, general creditors) with uninsured liabilities at the institution were certain of being paid, then there was essentially limitless deposit insurance which destroyed any market discipline. Although P&As minimized disruption to local communities

---

[3] Cash equivalents are assets that readily convertible to cash, such as accounts of the failed institution in other banks, known as "due from" accounts, and marketable securities.

[4] Franchise bidders are potential acquirers bidding only to acquire the failed institution's deposits or the "franchise."

[5] All resolution methods, including P&A transactions which pass *all* deposits to the assuming institution must pass the "least cost" test; see Chapter 2, The Resolution Process.

[6] The owners of uninsured claims are given receiver's certificates that entitle them each to a share of collections from the receivership estate. The percentage of the claims they eventually receive depends on the value of the institution's assets, the total dollar amount of proven claims, and the claimant's relative position in the distribution of claims. See Chapter 7, The FDIC's Role as Receiver for more details.

and to financial markets generally, they appeared to provide inequitable protection for uninsured depositors in large institutions.

Preference for Passing Assets

As the banking crisis became more acute toward the end of the 1980s, the FDIC tended to choose transactions that allowed a large proportion of the assets of a failing institution to pass to the acquirer. Those transactions were chosen for a variety of reasons. First, FDIC management became concerned that the accumulation of assets would drain the liquidity of the insurance fund. Former FDIC Chairman L. William Seidman (1985-1991), noting that prior to that time emphasis had not been placed on the sale of assets at resolution, wrote:

> This was not a serious problem in an agency with very few failed banks, and when the FDIC insurance fund had lots of cash…. But it could be disastrous as the number of bank failures increased…. The strategy of holding on to assets would swallow up all our cash very quickly…. Cash had never been a problem at FDIC, with billions in premium income on deposit at the Treasury. But my calculations showed that on the basis of the way we were doing things, if you took the FDIC forecast of bank failures from 1985 to 1990, our cash reserve of $16 billion would be wiped out well before the end of the decade.[7]

Second, although there is no empirical evidence, it was generally believed that after an asset from a failing bank was transferred to a receivership, the asset almost immediately suffered a loss in value.[8] This loss of value arose from several sources.[9]

> Loans had unique characteristics, and prospective purchasers had to gather information about the loans to evaluate them. This "information cost" was factored into the price outside parties paid for loans. This cost tended to be greater when assets were from failed institutions.
>
> Another reason for loss in value was disruption in financing for semi-completed projects. If the parties that made the financing loans were not available, it took time and effort to make decisions about further credit extensions. These delays may have caused disruptions in timing for operating or construction loans and may have contributed to a loss of asset value.

---

[7] L. William Seidman, *Full Faith and Credit: The Great S & L Debacle and Other Washington Sagas* (New York: Times Books, 1993), 100.
[8] This loss of value is known as the "liquidation differential," Frederick S. Carns and Lynn A. Nejezchleb, "Bank Failure Resolution: The Cost Test and the Entry and Exit of Resources in the Banking Industry," the *FDIC Banking Review* 5 (fall/winter 1992), 1-14.
[9] Testimony of John F. Bovenzi in the United States Court of Federal Claims, Civil Action No. 90-733C, *Statesman Savings Holding Corp. v. United States of America*.

> There was a natural reluctance on the part of receivers to make additional credit extensions, although they sometimes did so to preserve the value of the original loans. Receiverships were entities with limited life and did not operate to risk creating additional losses; receivers told borrowers of failed depository institutions to find new financing institutions. The time it took borrowers to find new lenders may have had an adverse effect on asset value.
>
> Borrowers, who did not need future business dealings with receivers, had more incentive to resolve problem loans with open banks or thrifts than with receivers. Borrowers from failed institutions frequently negotiated with receivers for reduced payments because they knew receivers were interested in expeditiously winding up the affairs of the failed institutions. The receivers calculated the losses of prolonged litigation versus the losses of reduced payoffs and chose the options with the highest net present value.
>
> Some assets lost their value simply because they were from a failed institution. Buyers were less comfortable purchasing assets of a failed institution than from ongoing entities. Assets of failed institutions were described as "tainted." Prospective purchasers felt greater risk in such purchases and made lower purchase offers.
>
> Receivership administrative costs may have reduced asset values. Things like operational costs, defense of litigation, and payment of claims reduced asset values (or correspondingly raised overall costs).
>
> There was also the idea of supply and demand. In a time when many institutions were failing, there were many receivership assets for sale. That situation may have created downward pressure on prices for those assets.

Third, as the FDIC began managing an extremely large portfolio of failed bank, several logistical problems began to develop. It became more desirable to pass assets to acquirers rather than to incur additional costs of acquiring, maintaining, and subsequently remarketing or collecting those assets.

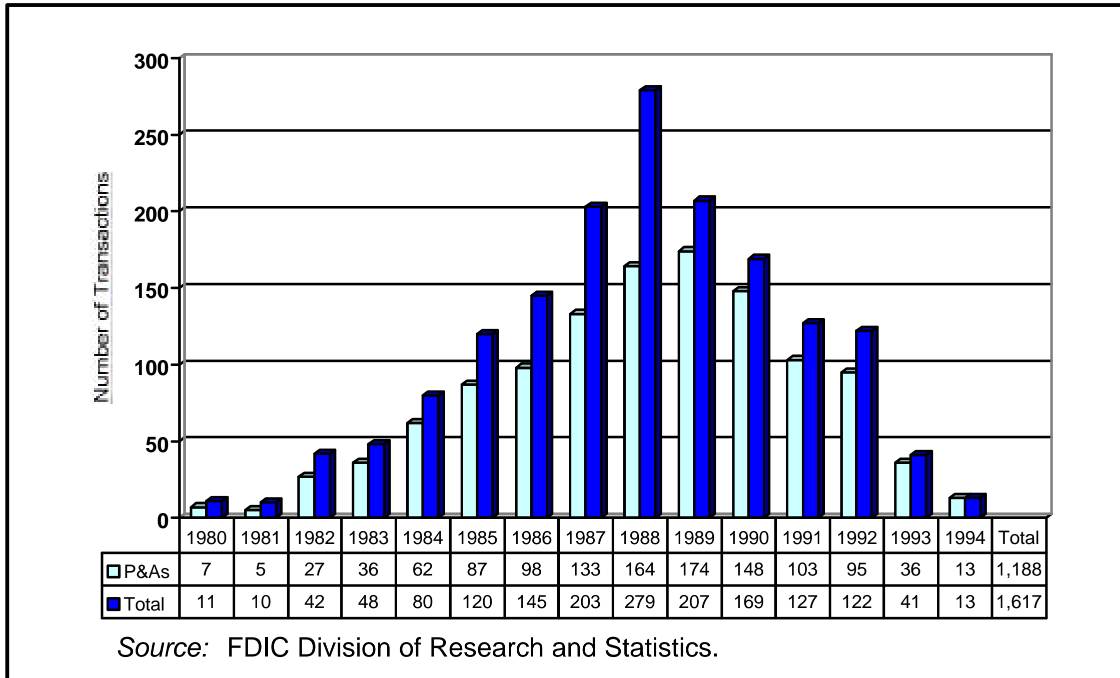
Fourth, it was simply considered more appropriate for private assets to remain within the private marketplace.

Finally, the FDIC saw the sale of the higher percentages of assets at resolution as a way to minimize disruption in the communities where failing banks were located.

From 1980 through 1994, the FDIC used P&A transactions to resolve 1,188 out of 1,617 total failures and assistance transactions, or 73.5 percent. Chart 3-1 shows the distribution of P&A transactions per year for this period.

Chart 3-1

FDIC Purchase and Assumption Transactions Compared to All Bank Failures and Assistance Transactions 1980-1994



	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	Total
P&As	7	5	27	36	62	87	98	133	164	174	148	103	95	36	13	1,188
Total	11	10	42	48	80	120	145	203	279	207	169	127	122	41	13	1,617

Source: FDIC Division of Research and Statistics.

Types of Purchase and Assumption Transactions

The P&A resolution structure has evolved over time to incorporate procedures and incentives to entice acquirers to take more assets of the failed institution. The following discussion describes some of the variations of the purchase and assumption transaction that the FDIC used under differing circumstances as appropriate.

Basic P&As

In basic P&As, assets that pass to acquirers generally are limited to cash and cash equivalents. The premises of failed banks and thrifts (including furniture, fixtures, and equipment) are often offered to acquirers on an optional basis; the price is based upon a post-closing appraisal that is mutually acceptable to the FDIC and the acquirer. The liabilities assumed by the acquirer generally include only the portion of the deposit liabilities covered by FDIC insurance.[10] The basic P&A was a valuable

[10] After the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 was signed, the FDIC was required to select the least costly resolution method available. The requirement had a significant effect on the FDIC's resolution practices. Previously, the FDIC had structured most of its transactions to transfer both insured and uninsured deposits along with certain failed bank assets. Under FDICIA, however, when transferring the uninsured deposits was not the least cost

resolution method in the early 1980s before the FDIC began allowing due diligence. Once the practice of due diligence was established, other variations of the P&A were used more frequently. Exhibit 3-1 shows the benefits and other considerations of basic P&As.

Exhibit 3-1

Basic P&As

Benefits

- *Customers with insured deposits suffer no loss in service.*
- *Customers with insured deposits have new accounts with new bank or thrift, but old checks can still be used.*
- *Customers with insured deposits do not lose interest on their accounts.*
- *Acquiring bank has the opportunity for new customers.*
- *Can be used when there is not enough time to complete due diligence.*
- *FDIC costs are reduced compared to a deposit payoff.*
- *Reduces the FDIC's initial cash outlay.*

Other Considerations

- *Receivership must liquidate the majority of the assets of the failed bank or thrift.*
- *Uninsured depositors may or may not suffer losses.*

Because of the tremendous increase in bank and thrift failures during the 1980s, the FDIC began to consider techniques and incentives to sell substantially more of the failed institution's assets to the acquirer. P&A transactions were restructured accordingly.

Loan Purchase P&As

In a loan purchase P&A, the winning bidder assumes a small portion of the loan portfolio, sometimes only the installment loans, in addition to the cash and cash equivalents. Installment loans are rarely the cause of the failing bank's troubles. Therefore, the installment loan portfolio is usually easy to transfer to the assuming institution. Loans that are past due 90 or more days may or may not be retained by the receiver. Typically, a loan purchase P&A transaction would pass between 10 percent and 25 percent of the failed institution's assets. Exhibit 3-2 shows the benefits of loan purchase P&As.

Exhibit 3-2

Loan Purchase P&As

Benefits

---

solution, the FDIC began entering into P&A transactions that included only the insured deposits.

- *All the benefits of the basic P&A, plus*
- *The FDIC passes a large number of small balance loans that are time-consuming for FDIC account officers to service.*

Modified P&As

In a modified P&A, the winning bidder purchases the cash and cash equivalents, the installment loans, and all or a portion of the mortgage loan portfolio. As with the installment loan portfolio, single family residential loans are rarely the cause of a bank's failure and, therefore, can be transferred to the assuming institution easily. Although in a period of rising interest rates, concessions may have to be made to guarantee a certain yield. Installment loans and mortgage loans usually provide the acquirer with a base of loans tied to the deposit accounts. Typically, between 25 percent and 50 percent of the failed bank assets are purchased under a modified P&A structure. Exhibit 3-3 shows the benefits of modified P&As.

Exhibit 3-3

Modified P&As

Benefits

- *All the benefits of the loan purchase P&A, plus*
- *The FDIC passes a portion of the mortgage loan portfolio; mortgage loans are time-consuming for FDIC account officers to service.*

P&As with Put Options

To induce an acquirer to purchase additional assets, the FDIC offered a "put" option on certain assets that were transferred. Two option programs for purchasing assets that the FDIC typically offered to acquirers were the "A Option," which passed all assets to the acquirer and gave them either 30 or 60 days to put back those assets they did not wish to keep and the "B Option," which gave the acquirer 30 or 60 days to select desired assets from the receivership. Structural problems existed, however, with both of the option programs, because an acquirer was able to "cherry pick" the assets, choosing only those with market values above book values or assets having little risk while returning all other assets. Also, acquirers tended to neglect assets during the put period, before returning them to the FDIC, which adversely affected their value.

In late 1991, the FDIC discontinued the put structure as a resolution method and replaced it with the loss sharing structure and loan pool structure. During the mid-1980s, however, the put option was seen as a way to preserve the liquidity of the insurance fund, by passing more assets to acquirers, thus lowering the amount of cash payments to assuming banks. Exhibit 3-4 shows the benefits and other considerations of P&As with put options.

Exhibit 3-4

P&As with Put Options

Benefits

- *All the benefits of the modified P&A, plus*
- *Fewer assets were retained by the FDIC.*
- *Allowed the acquirer time to complete due diligence after the P&A was finalized.*

Other Considerations

- *Acquirer was able to "cherry pick" the assets.*
- *Acquirers tended to neglect assets during the put period.*
- *Delayed the transfer of assets between the acquirer and the receiver.*

P&As with Asset Pools

In an effort to maximize the sale of assets during the resolution process and keep them in the local banking community, in 1991 the FDIC began offering a P&A transaction with optional asset pools for failing institutions with total assets under $1 billion. For banks with a diverse loan portfolio, the FDIC believes that it is preferable to break the loan portfolio into separate pools of homogeneous loans (that is, those with the same collateral, terms, payment history, or location) and to market the pools on an optional basis separately from the deposit franchise. The FDIC also groups nonperforming loans, owned real estate, and other loans that do not conform with one of the established pool structures into a single pool, which, depending on the overall quality of the pool, might be offered for sale. Bidders are able to bid (as a percentage of book value) on those loan pools that interest them, thus improving the marketability of the pools.

Potential acquirers are allowed to submit proposals for the franchise (all deposits or only insured deposits) and for any or all of the pools. The bidders may link the options as a package or they may bid on various combinations of pools.[11] The linked bid is evaluated as one "all-or-nothing" bid. The flexibility of this resolution method has allowed the FDIC to market a failing institution to significantly more potential acquirers, to transfer a higher volume of assets at resolution, and to allow for multiple acquirers.

This resolution strategy is designed to provide additional flexibility since each acquirer has a different interest. Some acquirers believe it is essential to acquire a substantial portion of the assets with the deposit franchise; other acquirers may prefer to purchase assets but do not believe it is essential to

[11] The largest number of bids ever submitted to date for one failing institution was 126 bids that were placed by only six potential acquirers.

acquire the franchise. There may be acquirers who do not want to purchase any assets, whereas other acquirers are willing to purchase assets only.

One problem with optional asset pools continues to be that many banking institutions are reluctant to acquire commercial assets, even at a discount, without a significant credit enhancement. Such enhancements may include the FDIC sharing in a credit loss, repurchasing assets that are found at some later date to have been misrepresented, or guaranteeing a specific rate of return on the acquirer's investment. Exhibit 3-5 shows the benefits and other considerations of P&As with optional asset pools.

Exhibit 3-5

P&As with Optional Asset Pools

Benefits

- *All the benefits of the modified P&A, plus*
- *Improves marketability of loans.*
- *Fewer assets are retained by the FDIC.*

Other Considerations

- *Many institutions are reluctant to purchase commercial credits without credit enhancements, even if the assets are purchased at a discount.*
- *Borrowers may have "split" lines of credit, that is, some loans with the acquirer and some with the FDIC, or even loans with multiple acquirers.*
- *Requires much pre-closing work for FDIC staff.*

Whole Bank P&As

The FDIC's preference for passing assets to acquirers became formal corporate policy on December 30, 1986.[12] The FDIC Board of Directors established an order of priority, known as "sequential bidding," for six alternative transaction methods based on the amount of assets passed to the acquirer.[13]

The whole bank P&A structure emerged as the result of an effort to induce acquirers of failed banks or thrifts to purchase the maximum amount of a failed institution's assets. Bidders were asked to bid on all assets of the failed institution on an "as is," discounted basis (with no guarantees). This type

[12] The policy was called the Robinson Resolution (named after Hoyle Robinson, executive secretary of the FDIC from May 7, 1979, to January 3, 1994). The resolution provided delegations to FDIC staff that allowed prioritizing the types of resolutions to be considered. The Robinson Resolution was revised and reissued in July 1992 and again in May 1997 to reflect the changes mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991.

[13] The six transaction types were, in order of preference, whole bank purchase and assumption, whole bank deposit insurance transfer and asset purchase, purchase and assumption, deposit insurance transfer and asset purchase, deposit insurance transfer, and straight deposit payoff.

of sale was beneficial to the FDIC for three reasons. First, loan customers continued to be served locally by the acquiring institution. Second, the whole bank P&A minimized the one-time FDIC cash outlay, and the FDIC had no further financial obligation to the acquirer. Finally, a whole bank transaction reduced the amount of assets held by the FDIC for liquidation.

The FDIC offered 313 whole bank transactions from 1987 through 1989 and received 130 successful bids. Whole bank P&As were consummated for 43 failing institutions in 1990. During this period when sequential bidding was in effect, bids for whole bank P&As were opened first and the highest whole bank bid that was less costly than a payoff was accepted. Bids for other resolution methods were returned unopened. If there were no acceptable whole bank bids, the next type of P&A bids were opened, followed by insured deposit transfer bids. Even though whole bank transactions passed the maximum amount of assets to the acquirers, the *least costly* resolutions may not have been chosen. With the introduction of the least cost test by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, however, the number of successful whole bank bids declined. Because a whole bank bid constitutes a one-time payment from the FDIC, bidders tended to bid very conservatively to cover all potential losses. Conservative whole bank bids could not compete with other transactions on a least cost basis. As a result, only 29 whole bank transactions were completed in 1991 and 1992.

Since FDICIA required the FDIC to open all bids received and to select the resolution determined to be least costly to the insurance fund, the FDIC abandoned sequential bidding. Indeed, it could no longer have been used even if viewed as desirable given FDICIA and its least cost test provisions. Exhibit 3-6 shows the benefits and other considerations of whole bank P&As.

Exhibit 3-6

Whole Bank P&As

Benefits

- *All the benefits of the P&A with optional asset pools, plus*
- *Loan customers continue to be served locally by the acquiring institution*
- *Minimizes the one-time FDIC cash outlay.*
- *Greatly reduces the amount of assets held by the FDIC for liquidation.*

Considerations

- *Seldom proves to be the least cost method in comparison to other types of resolutions.*

Loss Sharing P&As

A loss sharing P&A uses the basic P&A structure except for the provision regarding transferred assets. Instead of selling some or all of the assets to the acquirer at a discounted price, the FDIC agrees to share in future loss experienced by the acquirer on a fixed pool of assets. The FDIC learned from its experiences in the late 1980s and early 1990s that it is more desirable to keep the assets of a failed bank or thrift in the private banking sector than to take them over for liquidation.

Assets left in the banking sector retain more value than those placed in liquidation. Once assets are placed in receivership or liquidation, they lose value because of a break in the customer/institution relationship (the concept of liquidation differential was discussed earlier). Keeping the assets in the private banking sector softens the impact on the local community. The acquiring institution can work more easily with the borrowers to restructure the credits and advance additional funding where appropriate.

The FDIC originally developed the loss sharing concept in 1991 as a resolution tool for handling failed institutions with more than $500 million in assets. The FDIC designed loss sharing to address the problems associated with marketing large institutions with sizeable commercial loan and commercial real estate loan portfolios. In the past, acquiring institutions had been extremely reluctant to acquire commercial assets in the FDIC transactions for three reasons. First, the time allowed to perform due diligence is most often limited. The FDIC tries to accommodate a number of potential acquirers who wish to perform due diligence at the failing institution, and all acquirers must complete their reviews prior to the bid submission date. This allows very little time for any given bidder to perform more than a cursory review of an often complex loan portfolio.

Second, many acquirers are reluctant to purchase large portfolios of loans that they did not underwrite. In many cases, the underwriting standards of the failing institution are poor and may be a primary reason for the institution's failure. Also, information in the bank file may be limited or inaccurate. Acquirers wish to avoid the additional costs associated with managing and working out these potentially problem assets.

Finally, almost every region of the United States experienced declining commercial real estate markets in the late 1980s and early 1990s, causing considerable uncertainty about collateral values. Even when acquiring institutions were willing to purchase the commercial real estate loan portfolios, they incorporated large discounts into their bids to compensate for the additional risk of anticipated market declines.

Loss sharing P&As address these concerns by limiting the downside risk associated with acquiring large loan portfolios. The FDIC absorbs a significant portion of credit loss on commercial loans and commercial real estate loans, typically 80 percent, and acquiring institutions assume the remaining 20 percent of loss.[14] By having the acquirer absorb a limited amount of credit loss, the FDIC hopes to pass most of the failed institution's commercial loans and commercial real estate loans to the acquirer while still receiving a premium for the institution's deposit franchise. By having the acquirer absorb a portion of the loss, the FDIC is also attempting to induce rational and responsible credit management behavior from the acquirer. The FDIC also reimburses acquiring institutions for 80 percent of expenses, except overhead and personnel expenses, incurred in relation to the disposition or collection of the shared loss assets.

During the shared recovery period, which runs concurrently with the loss share period, the acquiring bank pays the receiver 80 percent of any recoveries (less any recovery expenses) on shared loss assets previously experiencing a loss. The shared recovery period generally lasts another one to three years beyond the expiration of the loss sharing period. Loss sharing provisions apply to all loans in a designated shared loss category, for example, commercial loans or commercial real estate loans, whether the loans are performing or not.

Loss sharing was also structured to include a "transition amount" so that if losses exceeded a projected amount, the FDIC would absorb a higher percentage of the losses beyond the projected amount, typically 95 percent. The transition amount was defined as the FDIC's estimate of the loss on the shared loss assets purchased by the acquirer. The FDIC used the transition amount to address the acquirer's concerns about catastrophic losses resulting from limited time for due diligence and uncertain collateral values stemming from deteriorating markets.

There are some negative aspects of the loss sharing structure. It requires both the FDIC and the acquirer to take on additional administrative duties and costs in managing the shared loss assets

[14] The percentage amounts to be split between the FDIC and the assuming institution can vary and are determined with every transaction.

throughout the life of the agreement. Some acquirers may find these added administrative duties and costs unacceptable, and the acquirers may lose interest in bidding.

Another concern in offering loss sharing is that many healthy, small financial institutions may not have the appropriate experience in working out problem assets. They may not have an interest in bidding if this is the only option, or they may acquire the assets but not manage them in the best interests of all involved. If this occurs, the FDIC loses control of the assets but is obligated to absorb a significant portion of the risk. In recognition of the different skills and interests of potential acquirers, the FDIC normally offers other resolution methods simultaneously with the loss sharing structure to encourage more institutions to bid.

Since it has been used generally in larger transactions, loss sharing has been very successful a number of times at keeping assets in the private banking sector and resulting in lower costs to the FDIC. On average, losses on assets covered by loss sharing have been approximately 6 percent of the beginning balances of the assets.

In cases where loss sharing is determined to be the preferred resolution structure for a transaction, the P&A agreement includes terms describing how charge-offs, recoveries, and expenses will be treated for the different types of assets.

Shared Loss Assets. Shared loss assets are generally commercial loans, commercial real estate loans, and owned real estate although some earlier agreements included additional types of loans.[15] The acquiring institution may subsequently take title to or transfer owned real estate to a subsidiary without forfeiting shared loss coverage.

Shared loss assets are initially recorded by the acquirer at the failed institution's book value. Thereafter, the value of a shared loss asset may be increased by additional advances,[16] capitalized expenses,[17] and accrued interest (subject to certain limitations); the value may be decreased by the amount of payments received and charge-offs recorded. Advances cannot exceed certain specified percentage limitations (generally 10 percent of the book value as of the agreement date), and are not allowed for any loan on which the acquiring institution has recorded a loss. Capitalized expenses are only permitted on owned real estate, and such expenditures must be capitalized in accordance with generally accepted accounting principles.[18]

---

[15] Consumer loans, home equity loans, residential mortgage loans, and loan participations are generally not part of a loss sharing agreement because those loans are of a better quality. Typically, performing consumer loans and residential mortgage loans pass at book value to the acquirer.

[16] Additional advances are funds given to a borrower after the original loan has been finalized; these amounts are added to the principal amount of the borrower's loan. For example, the bank might advance funds to pay taxes or to pay for harvesting a crop in the field.

[17] Capitalized expenses are major expenditures that typically involve real estate. The amount of money is treated as an asset by the borrower (increasing the value of the real estate) and not as a one-time expense. For example, the bank might provide funds to pay for remodeling a commercial building to make it more rentable. Expenditures for the remediation of environmentally contaminated real estate are excluded.

[18] In the United States, the Financial Accounting Standards Board is a private-sector organization empowered to establish

Shared loss loans may be amended, modified, renewed, or extended, and substitute letters of credit may be issued in lieu of original letters of credit. The amount of principal remaining to be advanced on a line of credit, however, may not be increased beyond the original amount of the commitment. Pay-downs on revolving lines of credit may be readvanced up to the original amount of the commitment. Terms may not be extended beyond the end of the final quarter through which the receiver has agreed to reimburse losses under the agreement.

Shared loss coverage ceases upon the sale of an asset or upon the making of advances or amendments that do not comply with the restrictions described previously. Shared loss coverage also ceases if the acquiring bank exercises collection preference regarding a loan held in its own portfolio that is made to or attributable to the same obligor as a shared loss loan.

Loss Sharing Arrangement. During the shared loss period, generally the first five years of the agreement, the receiver reimburses the acquiring institution for 80 percent of net charge-offs (charge-offs minus recoveries) of shared loss assets, plus reimbursable expenses. During the recovery period, generally the last two-year period of the agreement,[19] the acquiring institution pays the receiver 80 percent of recoveries, less recovery expenses.[20] Charge-offs are defined as write-downs of the principal amount of shared loss assets if such write-downs are taken in accordance with standards used by FDIC examiners. Losses on the sale of owned real estate are included, but losses on the sale of shared loss loans are generally excluded.[21]

Recoveries are defined as collections of (1) charge-offs of shared loss assets and reimbursable expenses, (2) charge-offs recorded by the failed bank (including charge-offs of consumer and residential loans recorded by the failed bank, whether or not such loan categories are designated as shared loss assets under the agreement), and (3) gains on the sale or disposition of real estate.

Reimbursable expenses are defined as out-of-pocket expenses paid during the shared loss period to third parties to effect recoveries and to manage, operate, and maintain owned real estate. (Expenses

---

financial accounting and reporting standards for the guidance and education of the public. These standards are referred to as "generally accepted accounting principles" or GAAP. In keeping with our free enterprise economy, it is appropriate that financial accounting and reporting standards be established by those that rely on them so heavily, that is, the participants in the private sector. Standard setting can remain in the private sector only with the support of its many constituent groups—the financial statement preparers, auditors, and those who make decisions based on information in financial statements.

[19] The term of the shared loss period varies from two to five years. The term of the shared recovery period runs concurrently with the shared loss period and for an additional one to three years. The loss sharing and recovery sharing percentages may also vary by transaction and by asset category.

[20] For those agreements that include a transition amount, at the termination of the agreement the receiver will also reimburse the acquiring institution an additional 15 percent of the amount by which aggregate charge-offs, reimbursable expenses, and recovery expenses, minus aggregate recoveries, exceeds the transition amount.

[21] While losses on the sale of loans are generally excluded to limit the receiver's exposure to interest rate risk, in cases where circumstances indicate that allowing the acquiring bank to sell loans may be in the receiver's best interest, coverage may be extended to include losses on the sale of loans. However, the FDIC establishes limitations regarding the dollar amount of loans that may be sold and the amount of resulting losses that may be eligible for reimbursement.

are reduced by income received on owned real estate.) An acquiring institution may not claim payments to affiliates. Expenses which are *not* reimbursable include income taxes; salaries and related benefits of employees; occupancy, furniture, equipment, and data processing expenses; fees for accounting and other independent professional consultants (other than legal fees and consultants retained for environmental assessment purposes); overhead or general and administrative expenses; expenses not incurred in good faith; and any extravagant expenses.

Transition Amounts (Catastrophic Insurance). Agreements included transition amounts, which were the FDIC's estimates of credit loss on the shared loss assets. If losses exceeded the transition amount, the acquirer was responsible for a smaller percentage of the additional loss, typically 5 percent, rather than the 20 percent typically covered for losses up to the transition amount. The FDIC transition amounts were for acquirers concerned about unanticipated losses resulting from limited due diligence time and uncertain collateral values resulting from deteriorating markets.

Certificates and Payments. Acquiring institutions file certificates within 30 days of the end of each calendar quarter during the shared loss period and the shared recovery period. The certificates report charge-offs, recoveries, net charge-offs (charge-offs less recoveries, amount may be negative), and reimbursable expenses (amount may be negative). If the shared loss amount is positive, the FDIC pays the acquirer 80 percent of the amount within 15 days of receipt of the certificate; if the shared loss amount is negative, the acquiring institution remits 80 percent of the amount with the certificate.

Administration of Agreement. The acquiring institution manages, administers, and collects shared loss assets consistent with usual and prudent business and banking practices and in a manner consistent with its own internal practices, procedures, and written policies. It may not contract with third parties for services on shared loss assets if it does not contract with third parties for those services for its own assets. Separate accounting records must be maintained for shared loss assets.

Within 90 days after each calendar year end, the acquiring bank must furnish the FDIC a report signed by its independent public accountants containing specified statements relative to the accuracy of any computations made regarding shared loss assets. It must also perform a semi-annual internal audit of shared loss compliance and provide the FDIC with copies of the internal audit reports and access to internal audit work papers. Additionally, the FDIC may perform an audit, of such scope and duration as it may determine to be appropriate to ascertain the bank's compliance with the assistance agreement. The FDIC provides formal procedures to resolve any disputes that may arise in connection with the loss sharing arrangement.

Loss sharing P&As are sometimes combined with other types of resolution agreements. For example, in the P&A agreements with New Dartmouth Bank, Manchester, New Hampshire, and First New Hampshire Bank, Concord, New Hampshire, the FDIC also agreed to provide shared loss coverage on the installment loans to ensure that those small balance assets with high service costs stayed with the acquirer. Table 3-1 lists the loss share agreements consummated from 1991 through 1993, and exhibit 3-7 shows the benefits and other considerations of P&As with loss sharing.

Table 3-1

FDIC Loss Share Transactions
1991-1993
($ in Millions)

Transaction Date	Failed Bank*	Location	Total Assets	Resolution Costs	Resolution Costs as % of Total Assets
09/19/91	Southeast Bank, N.A.**	Miami, FL	$10,478	$0	0.00 %
10/10/91	New Dartmouth Bank	Manchester, NH	2,268	571	25.18
10/10/91	First New Hampshire	Concord, NH	2,109	319	15.13
11/14/91	Connecticut Savings Bank	New Haven, CT	1,047	207	19.77
08/21/92	Attleboro Pawtucket SB	Pawtucket, RI	595	32	5.38
10/02/92	First Constitution Bank	New Haven, CT	1,580	127	8.04
10/02/92	The Howard Savings Bank	Livingston, NJ	3,258	87	2.67
12/04/92	Heritage Bank for Savings	Holyoke, MA	1,272	21	1.65
12/11/92	Eastland Savings Bank***	Woonsocket, RI	545	18	3.30
12/11/92	Meritor Savings Bank	Philadelphia, PA	3,579	0	0.00
02/13/93	First City, Texas-Austin, N.A.	Austin, TX	347	0	0.00
02/13/93	First City, Texas-Dallas	Dallas, TX	1,325	0	0.00
02/13/93	First City, Texas-Houston, N.A.	Houston, TX	3,576	0	0.00
04/23/93	Missouri Bridge Bank	Kansas City, MO	1,911	356	18.63
06/04/93	The First National Bank of Vermont	Bradford, VT	225	34	15.11
08/13/93	CrossLand Savings, FSB	Brooklyn, NY	7,269	740	10.18
	Total		**$41,384**	**$2,512**	**6.07 %**

*The banks listed here are the failed banks or the resulting bridge bank from a previous resolution, however, it is the acquirer that enters into the loss sharing transaction with the FDIC.
**Represents loss sharing agreements for two banks: Southeast Bank, N.A., and Southeast Bank of West Florida.
***Represents loss sharing agreements for two banks: Eastland Savings Bank and Eastland Bank.

Source: FDIC Division of Research and Statistics.

Exhibit 3-7

P&As with Loss Sharing

Benefits

- *All the benefits of a whole bank P&A, plus*
- *Reduced risk for the acquirer can lower FDIC's cost.*
- *FDIC's and acquirers' interests in the asset pools are closely aligned.*
- *Assets remain in the private sector.*

Other Considerations

- *Requires additional administrative duties for both the acquirer and the FDIC.*
- *Many healthy, small institutions may not have the expertise to manage a problem loan portfolio.*
- *Time-consuming as agreements generally last five to seven years.*
- *The FDIC does not control the assets yet retains a large portion of the potential loss.*

Bridge Banks

The Competitive Equality Banking Act of 1987 provided the FDIC with a new tool to help handle failing institutions: the bridge bank. A bridge bank transaction is a type of P&A in which the FDIC itself acts temporarily as the acquirer. This provides uninterrupted service to bank customers, while it allows the FDIC sufficient time to evaluate and market the institution.

A bridge bank is a new, temporary, full-service national bank chartered by the Office of the Comptroller of the Currency and controlled by the FDIC. It is designed to "bridge" the gap between the failure of a bank and the time when the FDIC can implement a satisfactory acquisition by a third party.

The original failed bank is closed by its chartering authority and placed in receivership. When appropriate, the FDIC establishes a bridge bank to provide the time needed to arrange a permanent transaction. It also provides prospective purchasers with the time necessary to assess the bank's condition in order to submit their offers. Absent systemic risk, the decision to "bridge" an institution must be based on whether a bridge bank structure will result in the least costly resolution for the failing institution.

The FDIC may establish a bridge bank in either its corporate or receivership capacity. However, the FDIC does not have the authority to bridge a thrift institution; in that instance the FDIC would have to use a conservatorship[22] instead of a bridge bank. A bridge bank can be operated for two years, with three one-year extensions, after which time it must be sold or otherwise resolved.

---

[22] A conservatorship is established when a manager has been appointed to take control of a failing financial institution to

Although not used very often, a bridge bank resolution is especially useful in situations when the failing bank is large or unusually complex. From the inception of the program in 1987 through 1994, the FDIC used the bridge bank method a total of 10 times to create 32 bridge banks from 114 separate institutions.[23]

Before establishing a bridge bank, a cost analysis must show that the estimated operating cost of the bridge bank is less costly than a payoff. A resolution timetable and strategy are also completed. The resolution strategy for the bridge bank will vary depending on whether the bridge bank is to be held long term (more than nine months) or short term (less than nine months). A bridge bank is established only if it is projected to be the least costly resolution alternative for the FDIC insurance fund.

The FDIC Board of Directors has broad powers to operate, manage, and resolve a bridge bank. A bridge bank operates in a conservative manner while serving the banking needs of the community. It accepts deposits and makes low-risk loans to regular customers. Its management goal is to preserve the franchise value and lessen any disruption to the local community. Performing assets, which are assumed by the bridge bank at their book value, enhance the bank's franchise value. Bank management may attempt to restructure nonperforming assets to increase their value.

The FDIC Board of Directors selects a chief executive officer (CEO)[24] to conduct day-to-day operations and appoints a bridge bank board of directors, composed of senior FDIC personnel and the CEO. The bridge bank board of directors is responsible for reviewing and approving the bank's business plan and for other management and oversight duties. The FDIC Board of Directors retains the authority to effect the bank's final resolution and approve the sale of the bank's assets.

Within 10 days after receiving the charter, the bridge bank's board of directors must develop and implement policies and procedures designed to guide operations safely and soundly, in line with the business plan. An operating budget is prepared to support the business plan's goals. If the CEO and the bridge bank board need assistance or additional expertise in specific areas, consultants may be hired on a short-term basis.

Lending. To prevent a significant outflow of commercial and retail loan customers, the bridge bank strives to maintain a profile in the local community. Specifically, the bridge bank is expected to make limited loans to the local community and to honor commitments made by the previous institution that

---

preserve assets and protect depositors. Conservatorships were primarily used by the RTC, however, the FDIC does have the power to establish conservatorships.

[23] Multiple failing banks in a bank holding company can be combined when creating bridge banks. For example, First RepublicBank Corporation, Dallas, Texas, was a holding company with 41 banks. The FDIC created two bridge banks, one for 40 banks in Texas and one for the bank in Delaware. On the other hand, First City Bancorporation of Texas, Inc., Houston, Texas, had 20 banks, and the FDIC formed 20 separate bridge banks.

[24] The CEO is not required to be an FDIC employee.

would not create additional losses for the institution, including advancing funds necessary for the completion of unfinished projects.

Assets. The bridge bank officials' primary focus on the asset side is to ensure that the value of the performing loans is retained and to identify problem assets that should be transferred to the receivership. Realistic market values are developed for assets by marking them to market (determining a realistic value based on present market conditions) and assigning appropriate loss reserves. If appropriate, assets may be sold. A complete asset inventory is taken to identify, evaluate, and work out troubled assets of the failed bank. The most problem-ridden assets with the least potential for improvement, including nonperforming loans, owned real estate, and fraud-related assets, remain in the failed bank receivership or are transferred to the receivership as soon as they are identified.

For a period of 30 to 90 days after the bridge bank is chartered, assets may be transferred to the receivership or they may be returned to the bridge bank from the receivership (which rarely happens). The bridge bank strives to "work out," or reduce, the volume of nonperforming assets. A workout program can offer a greater chance for recovery than other alternatives, such as foreclosure or litigation. Another cost-effective option is a compromise settlement. If a borrower cannot pay the full amount of the debt and if potential litigation costs are expected to be substantial, then the bridge bank may reach a compromise settlement with the borrower by accepting a repayment of less than the full amount.

Liabilities. Before its chartering authority closes the failing bank, the FDIC decides whether to pass all deposits or only insured deposits (those funds determined to be within the $100,000 insurance limit) to the bridge bank. Usually, only insured deposits are passed when there is an expected loss to the receivership. Customers with uninsured deposits share in any loss in the liquidation of the receivership with the FDIC. The FDIC must notify all depositors that their accounts have been transferred to the bridge bank, and the depositors must contact the bridge bank (or its successor institution) within 18 months to claim their deposits. Unclaimed deposits will be turned over to the respective state government. Typically, customers with deposits in the bridge bank do not lose any funds when an acquirer takes over the bridge bank.

Bridge bank management must decide whether to maintain or lower the interest rates paid on deposits by the failing bank. The FDIC requires that the rates remain the same for the first 14 days, and depositors must have 7 days' notice of any rate change. Customers with deposit agreements, such as certificates of deposit, may withdraw their funds without penalty until they agree to a new savings agreement.

Liquidity. The FDIC reviews the failing bank's liquidity during the bridge bank preparation phase. It monitors liquidity levels to determine if the bridge bank can meet its own funding needs or if it requires access to the FDIC's revolving credit facility. The bridge bank also attempts to re-establish lines of credit and correspondent banking relationships that were maintained by the failing institution.

Media Relations. Once the FDIC is appointed receiver of the failing bank, the FDIC issues a press release to inform the public of the actions the FDIC has taken and of its plans to resolve the failing bank. The public is kept apprised of all significant events during the bridge bank period. Once the bridge bank has been sold, a press release is issued to the public announcing the sale and the name of the acquirer.

Resolution. The sale and closing of a bridge bank is similar to the sale and closing of other failed banks. The FDIC requires at least 16 to 24 weeks to properly prepare for the sale, which includes gathering information, soliciting interest from potential acquirers, arranging for due diligence by potential acquirers, and receiving and analyzing bids. The bridge bank may be resolved through a P&A transaction, a merger, or a stock sale.[25] The most common resolution method for bridge banks is the P&A. Of the 32 bridge banks resolved, all but 2 were short-term, lasting seven months, or less.

The FDIC used its bridge bank authority in 1988 and 1989 to resolve 86 failed institutions of which 85 were affiliated with three large Texas bank holding companies. The FDIC resolved the three Texas bank groups by transferring all the problem assets from the bridge banks to the receiverships and selling the good portfolios to the acquirers with the option to require the FDIC to repurchase certain loans (put option). The acquirers also were given management contracts to service and to collect on the bad assets in the pools for the FDIC. The bad loan pools included foreclosed loans, classified loans, charged-off loans, and other classified assets.[26] Those problem assets were passed to the acquiring banks, which were reimbursed by the FDIC for the administrative costs of managing the pools and for the costs of carrying the problem assets. The FDIC also paid the acquirers incentive fees based on the amounts realized in liquidating the problem assets.

The put option was necessary due to the large size of the loan assets in the bridge bank. No matter how much due diligence was completed before the bid process, the acquirer needs additional time to properly evaluate the performing loan pools and the borrowers. The put options gave the acquirers two to three years to identify other assets that were or became problem assets (based on classification standards used by FDIC examiners) and to put such assets into the bad loan pools.

Some of the initial management contracts were costly for the FDIC and contained some overly generous incentives for the acquirers. Later bridge bank resolutions were modified so that the pools of bad assets were retained by the FDIC as receiver and managed by professional asset managers with more reasonable incentives. Even after this change, the acquirers of the bridge banks were still given limited options to return originally purchased assets to the receiver. Some recent resolution options have included loss sharing provisions. Table 3-2 shows the FDIC's use of bridge bank authority from 1987 through 1994, and exhibit 3-8 shows the benefits and other considerations of bridge banks.

---

[25] A bridge bank is essentially an asset of the receivership. As receiver, the FDIC controls all of the stock in the bridge bank.

[26] An FDIC examiner reviews assets to assess their credit quality. If an examiner concludes that an asset possesses characteristics or weaknesses that jeopardize the collection of the debt, then the asset is classified in the examination report according to its potential for loss.

Table 3-2

The FDIC's Use of Bridge Bank Authority 1987-1994

($ in Thousands)

Bridge Bank Situations	Failure Date	Bridge Banks	# of Failed Banks	Total Assets	Total Deposits
1	10/31/87	1 - Capital Bank & Trust Co.	1	$386,302	$303,986
2	07/29/88	2 - First RepublicBanks (Texas)	40	32,835,279	19,528,204
.	08/02/88	3 - First RepublicBank (Delaware)	1	* 582,350	* 164,867
3	03/28/89	4 - MCorp	20	15,748,537	10,578,138
4	07/20/89	5 - Texas American Bancshares	24	* 4,733,686	* 4,150,130
5	12/15/89	6 - First American Bank & Trust	1	1,669,743	1,718,569
6	01/06/91	7 - Bank of New England, N.A.	1	* 14,036,401	* 7,737,298
.	01/06/91	8 - Connecticut Bank & Trust Co., N.A.	1	* 6,976,142	* 6,047,915
.	01/06/91	9 - Maine National Bank	1	* 998,323	* 779,566
7	10/30/92	10 - First City, Texas-Alice	1	127,990	119,187
.	10/30/92	11 - First City, Texas-Aransas Pass	1	54,406	47,806
.	10/30/92	12 - First City, Texas-Austin, N.A.	1	346,981	318,608
.	10/30/92	13 - First City, Texas-Beaumont, N.A.	1	531,489	489,891
.	10/30/92	14 - First City, Texas-Bryan, N.A.	1	340,398	315,788
.	10/30/92	15 - First City, Texas-Corpus Christi	1	474,108	405,792
.	10/30/92	16 - First City, Texas-Dallas	1	1,324,843	1,224,135
.	10/30/92	17 - First City, Texas-El Paso, N.A.	1	397,859	367,305
.	10/30/92	18 - First City, Texas-Graham, N.A.	1	94,446	85,667
.	10/30/92	19 - First City, Texas-Houston, N.A.	1	3,575,886	2,240,292
.	10/30/92	20 - First City, Texas-Kountze	1	50,706	46,481
.	10/30/92	21 - First City, Texas-Lake Jackson	1	102,875	95,416
.	10/30/92	22 - First City, Texas-Lufkin, N.A.	1	156,766	146,314
.	10/30/92	23 - First City, Texas-Madisonville, N.A.	1	119,821	111,783
.	10/30/92	24 - First City, Texas-Midland, N.A.	1	312,987	289,021
.	10/30/92	25 - First City, Texas-Orange, N.A.	1	128,799	119,544
.	10/30/92	26 - First City, Texas-San Angelo, N.A.	1	138,948	127,802
.	10/30/92	27 - First City, Texas-San Antonio, N.A.	1	262,538	244,960
.	10/30/92	28 - First City, Texas-Sour Lake	1	54,145	49,701
.	10/30/92	29 - First City, Texas-Tyler, N.A.	1	254,063	225,916
8	11/13/92	30 - Missouri Bridge Bank, N.A.	2	2,829,368	2,715,939
9	01/29/93	31 - The First National Bank of Vermont	1	224,689	247,662
10	07/07/94	32 - Meriden Trust & Safe Deposit Co.	1	6,565	0
10	**Totals**	**32**	**114**	**$89,877,439**	**$61,043,683**

Data for Total Assets and Total Deposits is as of resolution.
Data marked with an asterisk (*) are from the quarter before resolution.

Source: FDIC Division of Research and Statistics.

Exhibit 3-8

Bridge Banks

Benefits

- *Provides the FDIC time to arrange a permanent transaction.*
- *Provides prospective purchasers the time necessary to assess the bank's condition in order to submit reasonable bids.*
- *Is an improvement over the deposit payoff or IDT alternatives.*

Other Considerations

- *Duplicates part of the resolution process; the FDIC must complete two closings, one for the original bank and one for the bridge bank.*
- *Takes much FDIC time and effort.*
- *The FDIC becomes responsible for the operation of the bridge bank.*
- *Difficult to retain key employees during this transition period.*
- *Economic conditions may continue to deteriorate, leading to lower premiums.*
- *Best customers may leave institution for more stable environment, thereby reducing the franchise value.*