PERSPECTIVES ON OPEN BANK ASSISTANCE

An Address By

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I'm pleased to have the opportunity to join you today and share a few thoughts about FDIC assistance to troubled banks. However, before I begin I must warn you -- we're taking the names of those who show more than idle curiosity about this topic.

What I'd like to do is briefly go over FDIC assistance (Section 13(c)), talk about some of the problems we face and finally provide an indication of what to expect from the FDIC in the future. I'll be happy to entertain questions at the end.

As background, let me emphasize a few principal points.

First, things have changed since the FDIC formulated its current written policy on open bank assistance. The number of commercial bank failures is up sharply and growing. Unlike past experience, many of today's failures largely result from severe economic conditions--not incompetent or dishonest management.

Second, the vast majority of failures are small commercial banks, a fact which focuses attention on the need for equitable treatment. This goal was sometimes overlooked in the past.

Third, a number of troubled institutions are subsidiaries of multibank holding companies. Assistance to such banks presents a series of questions which frankly were not contemplated when our existing policy was written. Among the more significant of these is the treatment and status of holding company creditors.

Fourth, free enterprise and the desire for market discipline mandate shareholders and management are held responsible for their actions. Assistance policies should not disrupt this relationship.

With these thoughts in mind, let me provide some history of FDIC assistance and an indication of where we are heading.

The FDIC first received authority to assist banks to prevent them from failing in 1950. Such assistance could be given only if continued operation was considered essential to provide adequate banking service in the community. With the number of banks and branches in most areas, essentiality was a pretty tough test. As you might expect, there was not a significant number of assistance transactions. Of course, there weren't many failures, either. Up until 1982, only five banks obtained assistance.

Normally, we either arranged a purchase and assumption transaction (P & A) or simply liquidated the bank and paid off insured depositors. Philosophically, the FDIC was opposed to giving assistance--we thought then (and still do) that it is best if unprofitable institutions are allowed to exit the marketplace. So we provided assistance only in those cases where the bank was just too big to handle with a P & A transaction (back then the FDIC could not go out-of-state to find a merger partner) and we were convinced a

payoff would have major adverse consequences for the community. Small banks simply weren't eligible for assistance unless there was some overriding consideration. In fact, the only small bank we assisted was Unity Bank, a special case because it was a minority-owned bank in Massachusetts.

In October 1982, Congress passed the Garn-St Germain Act. This Act had some pretty important provisions for dealing with troubled institutions. It authorized the net worth certificate program, which we have used successfully to assist mutual savings banks. It also gave the FDIC authority to look nationwide for bidders for large failed banks. Both tools proved to be useful, and as you know they expired Monday.

More relevant to our current topic, Garn-St Germain considerably expanded our authority for providing direct financial assistance to banks. Assistance could be provided in any case where the cost would be less than that of closing and liquidating the bank.

Although this law clearly expanded our powers, the philosophical view was open bank assistance should be avoided except perhaps to facilitate the acquisition of a failing bank. The dominant concern was assistance would represent an undue benefit for an institution's shareholders.

This philosophy was reflected in the Board's 1983 policy statement which established the basic criteria for an assistance transaction. They are:

(1) Executive management, directors, shareholders and subordinated creditors should not receive financial benefit greater than they would have if the bank had closed;

(2) Any funds obtained from nonbook sources such as recoveries on charged off assets, bond claims, and claims against officers and directors would flow to the FDIC until assistance was repaid;

(3) The bank must obtain new sources of capital sufficient for it to operate; and

(4) Assistance must represent the least costly alternative for the FDIC. We also described a variety of criteria which elaborated upon these policies.

These policies were intended to support our basic belief that institutions must be allowed to fail; and that shareholders, creditors and uninsured depositors must not be protected from financial loss.

It also made clear that active management and directors should not escape the normal legal and financial liability associated with the inadequate performance of their duties. In other words we did not, and still do not, want to bail out the losers.

Under these policies, the FDIC has agreed to provide assistance to only three banks so they could remain operating entities. One was Continental. The other two were approved within the past six months. They are The Talmage State Bank--a $10 million institution--and Bank of Oklahoma. The other assistance arrangements were designed to facilitate open bank mergers.

In recent months, requests for assistance have increased significantly. Currently, we have around half a dozen applications from commercial banks under consideration in Washington, plus others in the field. In addition to these applications we have been approached by numerous other institutions.

The most common problems with unsuccessful requests were they were not cost effective or management responsible for the banks' problems would have benefited. Other problems included requests designed primarily to bail out the bank stock lender or shareholders and/or the bank was not considered in danger of failing.

Today, we find that we must meet new situations and develop innovative packages to meet the increasing supply of failed and failing banks (150 or more expected this year). We must deal with failures of units in multibank holding companies and one bank holding companies, large and small. Constructing a lower cost alternative for the insurance fund is an increasing challenge.

Given this environment it makes sense for the FDIC to review its policy toward open bank assistance. We do adhere to the general philosophy behind our current policy; but, at the same time, we want to increase our options for providing open bank assistance where it is cost effective and beneficial to the stability of the system.

In this regard our present written policy presents some difficulty. One obstacle is the requirement that shareholders and subordinated creditors (and those standing behind them, holding company creditors) be no better off than if the bank had closed. This presents two practical problems.

One, any program which benefits the bank will eventually provide some benefit to shareholders and creditors. Second, without the opportunity for some marginal benefit, shareholders and creditors will have no incentive to consummate an assistance transaction which could result in substantial savings for the FDIC. Thus, while we consider a bailout clearly inappropriate, a total wipeout is not always in the insurance fund's best interest. Nor is it always justified.

Assistance transactions are particularly difficult in holding company situations. Our underlying philosophy is there is an obligation on the part of the whole organization to the health of each affiliate. The failure of one bank within a holding company could well lead to the failure of other banks in the organization. Problems should not be viewed on a stand alone basis.

In that respect we anticipate shareholders and creditors of the holding company will share in some of the loss, not unlike what would have occurred if one of the banks in the holding company failed. But again, a total wipeout is not required. This would not necessarily be the likely result if only one ailing subsidiary bank failed. Thus, the FDIC should seek a contribution from the holding company to reflect the equivalent of failure of a part of the holding company. And, that contribution must be significant.

Two recent examples demonstrate some of the problems and alternative approaches to dealing with failing banks and their holding companies.

Recently, the First National Bank of Oklahoma failed. In this case an open bank assistance transaction was explored but the effort was not successful. Quite frankly, the institution had deteriorated significantly. The failed bank was the principal asset of the parent holding company. Thus, the interests of holding company shareholders and creditors in the bank were virtually eliminated.

This demonstrates a key point. Creditors of a holding company are not in the same position as creditors of a bank. They are in a position similar to bank shareholders.

Let me compare this approach to the one used for the Oklahoma City based Bank of Oklahoma. At Bank of Oklahoma, the holding company was highly leveraged and because of operating losses could not raise new funds in the marketplace. The subsidiary bank accounted for only 20 percent of the holding company's consolidated assets. It was about to fail. The recognized inability of the holding company to deal with the situation began to cause funding problems at the lead bank in Tulsa. If the Oklahoma City bank had failed, liquidity pressures could well have lead to the failure of other affiliated banks.

What we agreed to do is assume $40 million of the bank's loans from the Federal Reserve and also purchase $90 million of cumulative convertible preferred stock. In return the FDIC will receive warrants at a nominal price representing 55 percent of the bank holding company's stock.

Provided the FDIC's preferred stock is redeemed, the holding company may repurchase up to 80 percent of the FDIC's warrants at a price which repays most of our $40 million loan. The remaining 20 percent remain with the FDIC. In addition, dividends will not be paid on stock of the parent holding company for an extended period. The basic idea was to structure a transaction that provided temporary capital along with incentives for the holding company to repay the FDIC. Failing that, shareholders would suffer substantial dilution.

Moreover, creditors of the holding company agreed to convert $23 million, or just over 30 percent of their debt, to a capital instrument. They will earn no interest for three years and a below market rate thereafter.

Negotiations on this transaction resulted in several new twists to our existing policy statement.

The FDIC did not take out assets as a part of the assistance plan nor did we obtain first rights to recoveries from charged off assets. Incentives were provided to the bank to maximize revenues from all sources, through penalties which increase with the amount of time that FDIC assistance remains outstanding. There was a small amount of widely owned subordinated debt in the bank. These creditors did not suffer the loss they probably would have experienced had the bank failed (because there was no way to negotiate such concessions on a timely basis).

Assistance clearly appeared to be least expensive route for the FDIC. It helped preserve the value of both the bank and the entire holding company system. At the same time it was not a free ride. Shareholders and line bank creditors all gave material concessions.

In conclusion, let me summarize where we are.

Recent open bank assistance transactions have been considered for the following reasons:

One, they provide the opportunity for substantial savings to the insurance fund.

Two, they provide a mechanism for keeping loans and other assets within the banking system. Borrowers will be dealing with bankers, not liquidators.

Three, they can minimize the disruption to the local community which results from bank failures.

However, these advantages have to weighed against the substantial disadvantages of the FDIC's short term (hopefully) involvement in the private sector through its ownership of warrants, preferred stock or loans.

Thus, Section 13 assistance to open banks involves a complex situation in which advantages and disadvantages must be weighed by the Corporation. The Board of the FDIC will be considering these factors as it deals with further policy statements in the area of open bank assistance.