CHAPTER 5 – OPEN BANK ASSISTANCE TRANSACTIONS

The third basic resolution method for failing financial institutions is an open bank assistance (OBA) transaction.[1] In an OBA, the Federal Deposit Insurance Corporation (FDIC) provides financial assistance to an operating insured bank or thrift to keep it from failing. The FDIC can make cash contributions to, make loans to, purchase the assets of, or place deposits in the troubled bank or thrift.[2]

Structure of an Open Bank Assistance Transaction

Open Bank Assistance can be used to facilitate the acquisition of a failing bank or thrift by a healthy institution. An OBA transaction is very similar to a whole bank purchase and assumption in that the majority of the failing institution's assets remain intact. While an OBA can be structured in several ways, the FDIC's ultimate goal is minimizing cost to the deposit insurance funds.

A major criticism of OBA, however, is that shareholders of failing institutions have benefited from the assistance provided by the government, even though most of the OBA transactions required the shareholders of the failing institutions to significantly dilute their ownership interests. Generally, the FDIC required new management, ensured that the ownership interest was diluted to a nominal amount, and called for a private-sector capital infusion. A 1993 amendment to the Federal Deposit Insurance Act (FDI Act) of 1950 prohibited the use of insurance fund monies in any manner that benefits any shareholder of an institution that had failed or was in danger of failing. That amendment made obtaining assistance even more difficult than in the past for open institutions.

Before the FDIC can provide open bank assistance, it must establish that the assistance is the least costly to the insurance fund of all possible methods for resolving the institution. The FDIC may deviate from the least cost requirement only to avoid "serious adverse effects on economic conditions or financial stability" or "systemic risk" to the banking system.[3] The appropriate federal banking agency or the FDIC must also determine that the institution's management is competent, has complied with all applicable laws, rules, and supervisory directives and orders, and has never engaged in any insider dealings, speculative practices, or other abusive activity.

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[1] There are several types of assistance to open banks, including forms of cash and noncash assistance. To the FDIC, the term "open bank assistance" refers specifically to a resolution method where financial assistance is given to a troubled bank or thrift to prevent its failure. See Chapter 6, Other Resolution Alternatives for a discussion of other types of assistance to open institutions.

[2] In open bank assistance agreements, the FDIC provides a cash contribution to restore deficit capital to a positive level (referred to as "filling the hole"). For a large institution, the FDIC may use a note or loan to fill the hole. Additionally, the FDIC may cover losses for a specific amount on a pool of assets over a specified period of time.

[3] Only the secretary of the Treasury has the power to grant this exception, after consulting with the president of the United States and with the recommendation by two-thirds of the boards of directors of the FDIC and the Federal Reserve System.

Since the inception of OBA in 1950,[4] the legislative process and public policy have transformed OBA. Originally, the FDIC could grant OBA only if the institution's continued existence was determined to be "essential" to the community.[5] This was seldom deemed to be the case as only four institutions received OBA from 1950 to 1979. In 1982, the FDIC received broader authority from the U.S. Congress with the passage of the Garn-St Germain Depository Institutions Act (Garn-St Germain) to provide OBA. For example, the FDIC no longer had to satisfy the essentiality test; an institution could receive assistance if the FDIC Board of Directors determined that the amount of assistance was less than the cost of liquidating the institution.

In 1986, the FDIC revised its policy statement on OBA to provide guidance to FDIC insured banks in danger of failing on the general conditions and terms that a request for OBA should include. The policy statement was revised because the number, size, and complexity of bank failures had increased dramatically, as had requests for assistance. The 1986 policy statement required the following:

- The FDIC's cost in providing assistance must be less than if the FDIC took alternative action (which at the time was considered to be the cost of liquidation),

- The assistance proposal must provide for sufficient capitalization including capital infusions from non-FDIC sources, and

- The financial effect of the assistance upon shareholders and subordinated debtholders of the bank or the bank's holding company must approximate the same effect on those parties had the bank failed.

The statement also covered renegotiations of management contracts, avoidance of an equity position for the FDIC in a bank, the FDIC's preference not to acquire or service the assets of assisted banks, the responsibility for pursuing legal claims against bonding and insurance companies, and fee arrangements.[6]

The FDIC completed the majority of the OBA agreements (with 98 institutions) in 1987 and 1988.[7] Those transactions represented approximately 20.3 percent of the total OBA and failure transactions during those years. One reason for the increase in OBA transactions was that the FDIC instituted a policy to communicate to bankers the deficiencies of their assistance proposals and to allow them to make adjustments to conform to the policy statement. If the proposal cost less than liquidation, FDIC staff would recommend the open bank assistance proposal without requesting closed bank bids. Another reason for the increase in OBA transactions was the existence of federal income tax benefits,

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[4] Federal Deposit Insurance Act, *U.S. Code*, volume 12, section 1823(c)(1).

[5] For a discussion of the history of the essentiality issue, see Henry Cohen, "Federal Deposit Insurance Corporation Assistance to an Insured Bank on the Grounds that the Bank is Essential in Its Community," Congressional Research Service (October 1984).

[6] FDIC News Release, "FDIC Revises Policy on Assistance to Failing Banks," PR-189-86 (December 2, 1986).

[7] In 1987, 11 of the 19 assistance transactions were with BancTexas Group institutions. For 1988, 59 of the 79 assistance transactions were with First City Bancorporation of Texas, Inc. institutions.

including relaxed rules for tax-free reorganizations, favorable rules regarding carry forwards of net operating losses, and favorable tax treatment of assistance payments received by the failing banks from the FDIC.[8] In 1989, however, with passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), many potential tax benefits associated with open bank assistance were repealed.[9]

The number of OBA transactions decreased significantly after 1988. Of the 625 failed or failing banks handled by the FDIC from 1989 through 1992, only 7 were resolved by open bank assistance. The decline in OBA can be attributed, in part, to the following factors:

- In 1989, the FDIC began comparing the cost of OBA proposals within a competitive bidding process. In most cases, the closed proposals were less costly to the insurance fund,[10] or the proponents for open bank assistance failed to satisfy the criteria.

- The passage of FIRREA in 1989 repealed many of the potential tax benefits listed above. Furthermore, the FDIC had to consider any tax benefits when evaluating bids, that is, if the transaction resulted in a lower federal tax liability for the acquirers, that decrease in taxes had to be added to the cost of the transaction.

- The Competitive Equality Banking Act (CEBA) of 1987 authorized the FDIC to establish a bridge bank, which allowed the FDIC additional time to find a permanent solution for resolving a failing bank. Furthermore, with a bridge bank the FDIC could simply leave all bondholders' and shareholders' claims behind in a receivership, and the bondholders and shareholders would have no bargaining power. The FDIC handled the three largest bank failures in 1989 using the bridge bank structure.

In April 1990, the FDIC's policy was revised to reflect certain amendments to section 13(c) of the FDI Act and the addition of section 13(k)(5) as enacted in FIRREA. Section 13(k)(5) dealt with providing assistance to troubled savings associations before they were placed into the Resolution Trust Corporation's conservatorship program. None of the savings and loans that applied to the FDIC for open assistance was approved, however, because they failed to meet the criteria factors.

The FDIC's 1990 Statement of Policy on Assistance to Operating Insured Banks and Savings Associations retained some of the criteria from the 1986 policy statement and added several new

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[8] Thomas D. Phelps and Sean M. Scott, "Investment Opportunities Afforded By Open Bank Assistance," *Banking Expansion Reporter* (February 6, 1989), 8-10.

[9] FIRREA repealed certain provisions of the Technical and Miscellaneous Revenue Act (TAMRA) of 1988, which allowed purchasers of failing institutions to take advantage of certain tax benefits. While TAMRA was in effect, the FDIC attempted to ensure that the tax benefits effectively accrued to the insurance fund by reducing the amount of assistance provided for both open and closed transactions.

[10] Closed bank transactions offer advantages over open bank transactions because, in a closed bank transaction, contingent liabilities can be eliminated, burdensome leases and contracts can be terminated, and troublesome assets can be left in the receivership. Furthermore, uninsured depositors and unsecured creditors can share in the loss.

factors. Some of the more important factors were that (1) acceptance of proposals by the FDIC would be within a competitive bidding process, (2) institutions requesting assistance had to agree to unrestricted due diligence by all parties cleared by the FDIC, and (3) proposals had to quantify limits on indemnities and guarantees.[11] The guidelines and criteria for assistance proposals were flexible and the FDIC was receptive toward innovative ideas from investors in structuring OBA proposals.

In 1992, the FDIC again revised its policy statement for open bank assistance. The revision mainly reflected changes mandated by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, which included the possibility of "early resolution" of institutions that were troubled, and the requirement that failing institutions generally be resolved in the manner that was least costly to the deposit insurance fund. The policy statement also required the FDIC to make certain findings with respect to ongoing management of the institution.[12] The 1992 policy statement detailed 19 criteria for evaluating proposals and identified certain information that should be included in a proposal.

With the passage of an amendment to section 11 of the FDI Act in 1993, the FDIC was prohibited from using insurance fund monies in any manner that benefited any shareholder of an institution that had failed or was in danger of failing. The passage of this statute has virtually eliminated the possibility of OBA, except in the cases of a systemic risk determination. Therefore, in 1997 the FDIC Board of Directors decided to rescind the 1992 policy statement and consider proposals from open, failing institutions based only on current statutory requirements (that is, least cost, management competence, and no benefit to former shareholders). Table 5-1 shows the number of open bank assistance transactions completed per year in relation to the significant legislation passed during that year.

[11] FDIC, Financial Institution Letter, "Policy Statement on Assistance to Operating Insured Banks and Savings Associations," April 6, 1990, FIL-27-90.

[12] Section 13(c)(8) requires management of the resulting institution to be competent and to have complied with applicable laws.

Table 5-1

Summary of Open Bank Assistance Transactions

Significant Legislation	Year	Number of Banks Receiving Open Bank Assistance	Total # of Bank Failures and Assistance Transactions
FDI Act of 1950	1950-1970	0	82
(essentiality test)	1971-1979	4	73
	1980	1	11
	1981	3	10
GARN-ST GERMAIN	1982	8	42
(less costly than a liquidation)	1983	3	48
	1984	2	80
	1985	4	120
	1986	7	145
CEBA	1987	*19	203
(bridge bank authority)	1988	**79	279
FIRREA	1989	1	207
(repeal of tax benefits)	1990	1	169
	1991	3	127
FDICIA (least cost test)	1992	2	122
TOTAL	**1950-1992**	**137**	**1,718**

* Includes 11 BancTexas Group, Inc. institutions that were part of one transaction.
** Includes 59 First City Bancorporation of Texas, Inc. institutions that were part of one transaction.
Source: FDIC Division of Resolutions and Receiverships.

Assistance to Continental Illinois National Bank and Trust, Chicago, Illinois

The term "open bank assistance" gained national recognition in 1984 when the FDIC provided assistance to Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois. At its peak in 1981, Continental was the largest commercial and industrial lender in the United States, although it was not the largest bank. As of March 31, 1984, shortly before its resolution, the bank held approximately $40 billion in assets. Continental had followed a high-risk expansion strategy based on the rapid growth of its loan portfolio, which was funded by volatile, short-term liabilities. Continental had purchased energy loan participations from Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma. Those loans contributed significantly to the more than $5.1 billion in nonperforming loans Continental held in 1982. After Penn Square's failure, confidence in Continental, particularly among its many international customers, was severely shaken. As a result, a rapid and massive electronic deposit run began in early 1984. The FDIC's options in resolving Continental were either to payoff the customers with insured deposits, to merge the institution, or to provide direct open assistance.

The FDIC ruled out a payoff of customers with insured deposits because of the negative effect it would have had on other banks and the economy. This negative effect included a potential liquidity crisis for other banks with significant foreign deposits, a decrease in foreign investor confidence in U.S. institutions, a severe blow to the unaffiliated depositor banks, and a negative effect on financial markets in general. Many small banks had correspondent bank accounts and federal funds sold to Continental, placing those funds at risk should Continental fail. For the FDIC, permitting Continental to fail and then paying off only the insured depositors was not considered to be a feasible option. With more than $30 billion in uninsured deposits, a liquidity failure would have occurred without FDIC assistance; such a failure could have caused other bank failures and tied up creditors in bankruptcy for years.

The FDIC Board of Directors decided that a payoff of Continental's insured deposits could cause panic in the financial and banking markets. Former FDIC Director Irvine H. Sprague (1969-1972 and 1979-1985) wrote:

> Insured deposits were then estimated at about $4 billion, barely 10 percent of the bank's funding base. At first glance, a payoff might have seemed a temptingly cheap and quick solution. The problem was there was no way to project how many other institutions would fail or how weakened the nation's entire banking system might become. Best estimates of our staff . . . were that more than two thousand correspondent banks were depositors in Continental and some number—we talked of fifty to two hundred—might be threatened or brought down. . . . The only things that seemed clear were not only that the long-term cost of allowing Continental to fail could not be calculated, but also that it might be so much as to threaten the FDIC fund itself.[13]

Merging Continental on a closed basis was not viewed as a viable option because prospective purchasers would have needed a significant amount of time to evaluate the bank. In addition, it would have required significant FDIC financial involvement to protect against uncertainties, such as contingent liabilities.[14]

The FDIC elected to provide direct assistance to Continental. Because of this deposit run, on May 17, 1984, the FDIC gave its assurance to protect all depositors and other general creditors of Continental against loss. A temporary capital infusion of $2 billion was made to provide liquidity and to halt a run on deposits until a permanent solution could be arranged. The permanent solution involved replacing senior management, purchasing $4.5 billion in problem loans for $3.5 billion, and

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[13] Irvine H. Sprague, *Bailout* (New York: Basic Books, Inc., 1986), 155.
[14] William M. Isaac, Chairman, Federal Deposit Insurance Corporation, "Statement on Federal Assistance to Continental Illinois Corporation and Continental National Bank Presented to Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, House of Representatives," October 4, 1984, 3.

injecting $1 billion in capital. In exchange, the FDIC received the right to purchase 80 percent ownership in the parent company, Continental Illinois Corporation.[15] As a result, the shareholders of the parent company suffered an 80 percent dilution of their investments, and the shareholders further became subject to losing their entire investment depending on the losses suffered by the FDIC in collecting the problem loans.[16]

The assistance agreement with Continental created tremendous outcries from critics for several reasons. First, the FDIC guaranteed all depositors and other general creditors, thus assuming their share of loss and removing the market risk. Second, it was generally believed that the FDIC should have penalized the shareholders to a greater degree.[17] Third, the agreement called for the FDIC to receive a majority equity interest, effectively nationalizing the institution. Finally, the issue of "Too Big to Fail"[18] created resentment by many of the smaller institutions due to their belief that the resolutions of larger institutions were treated differently from those of smaller banks. Assisting Continental sowed the seed for future legislation that addressed each of these points. The assistance provided to Continental accomplished the FDIC's objectives of stabilizing liquidity, preventing Continental's failure, and restoring Continental's capital to an adequate level. The assistance also proved to be cost-effective for the FDIC.

Results of Open Bank Assistance

The majority of open bank assistance transactions completed between 1980 and 1983 involved mutual savings institutions. Assistance was in the form of a merger or acquisition, and the remaining institutions were recapitalized on a stand-alone basis. The FDIC's methods for handling these institutions were varied and included contributing cash, purchasing assets, offering income maintenance guarantees, issuing FDIC notes, purchasing the institution's stock, and/or indemnifying against certain types of losses. Most of the acquirers adequately capitalized the institutions. In some cases cash was contributed, and in the other agreements the acquirer's current capital position was sufficient to absorb the assisted institutions. The importance of this is that the investors assumed some risk and brought fresh capital into the banking system. Replacement of management and the dilution of shareholders' interest also characterized the open bank assistance transactions.[19]

Since the Continental transaction, an additional 117 institutions received OBA through year-end 1994. All of those transactions were entered into because they were viewed to be less costly than a

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[15] Isaac, 4-5.
[16] Isaac, 4.
[17] The holding company for Continental owned 100 percent of the bank. The shareholders of the holding company suffered an 80 percent dilution with the possibility of losing their entire investment.
[18] Most of the institutions considered "Too Big to Fail" were actually closed; however, certain troubled institutions were too large to be resolved by paying off their customers with insured deposits. A straight deposit payoff of such an institution could have had a devastating effect on the deposit insurance fund. A more accurate name might be "Too Big to Pay Off All Deposits."
[19] There were a few cases where senior management was not replaced. In each case it was determined that the current management was not considered the cause of the problem.

payoff of customers with insured deposits. Several of the transactions completed in 1984 and 1985 were approved under the FDIC's Voluntary Assisted Merger Plan, under which the FDIC took direct action to arrange a merger of a failed or failing insured bank with another insured bank.

In 1986, former FDIC Chairman L. William Seidman (1985-1991) told the Association of Bank Holding Companies that there are three potential advantages of open bank assistance:

> They can provide substantial savings to the insurance fund when compared with the cost of closing a bank;
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> They provide a mechanism for keeping loans and other assets within the banking system since all borrowers would be dealing with bankers instead of liquidators; and
>
> They can minimize the disruption to the local community that may result from bank failures.[20]

In addition, Chairman Seidman stated: "There is nothing wrong with assisting a bank, but the advantages have to be 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 in the rescued institution."[21]

From 1980 through 1994, the FDIC provided OBA to 133 institutions out of 1,617 total failures and assistances, or 8.2 percent of the total. Nearly 75 percent of all OBA transactions were completed in 1987 and 1988. Public policy has significantly affected OBA, and in many cases the FDIC has had to wrestle between its role as regulator and insurer against that of investor. OBA has been controversial for several reasons.

- First, OBA allowed weak institutions to remain open and compete with nonassisted institutions.

- Second, shareholders and creditors of failing institutions, while losing substantial portions of their investments, did not lose everything because of OBA.

- Third, many of the OBA transactions were used to resolve larger institutions, resulting in resentment by many of the owners of smaller institutions.

- Fourth, some of the OBA transactions provided significant tax benefits to the acquirers at a cost to the U. S. taxpayer that appeared to exceed any financial benefit received by the government.

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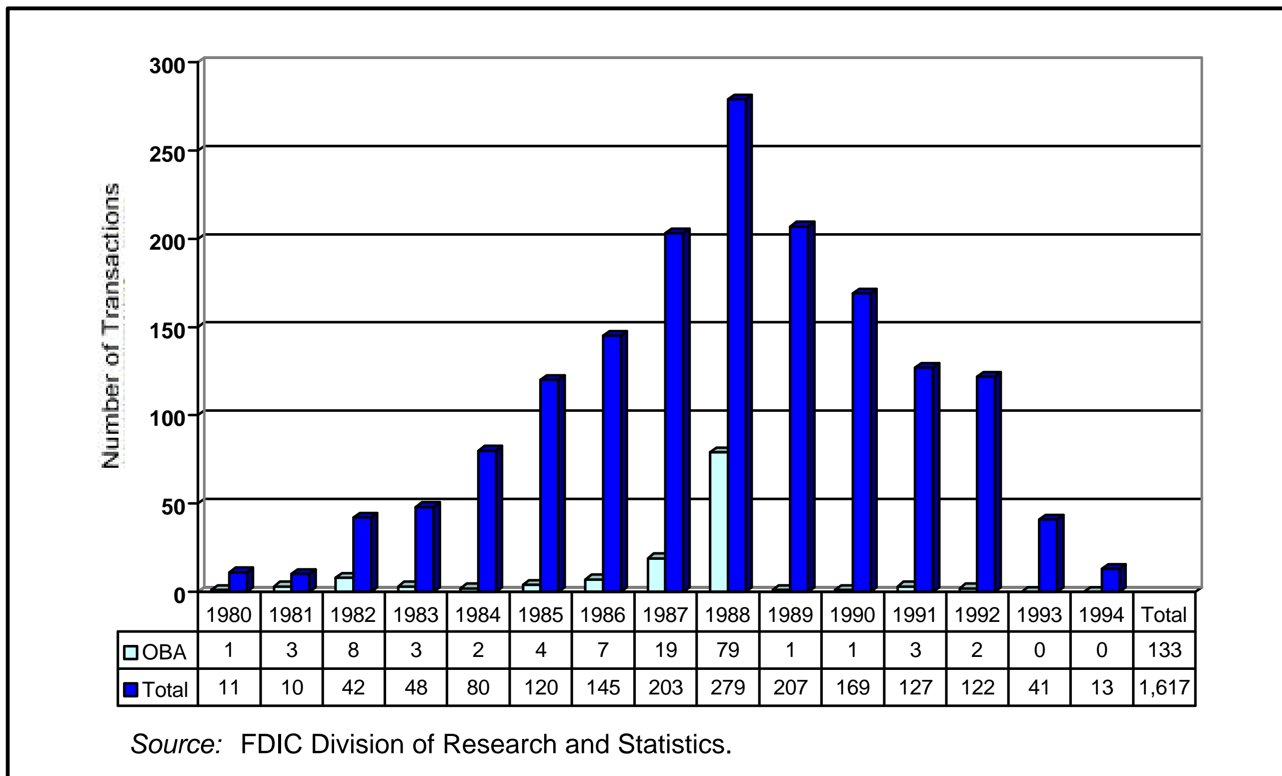
[20] L. William Seidman, *Perspectives on Open Bank Assistance*, (Washington, D.C.: Government Relations Committee of the Association of Bank Holding Companies, September 17, 1986), 5.
[21] Seidman, 5.

- Fifth, OBA protected all uninsured depositors, which had the result of reducing depositor discipline.

Because of these controversial issues, legislation has been adopted that makes it extremely difficult to complete an OBA transaction. FDICIA, which requires the FDIC to use the least costly method for resolving a failing institution, is intended to provide greater incentives for shareholders and large creditors of insured banks or thrifts to impose more discipline on the management of insured institutions to operate safely and soundly. Chart 5-1 shows the distribution of open bank assistance transactions per year from 1980 through 1994, and exhibit 5-1 shows the benefits and other considerations of open bank assistance.

Chart 5-1

FDIC Open Bank Assistance 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
OBA	1	3	8	3	2	4	7	19	79	1	1	3	2	0	0	133
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.

Exhibit 5-1

Open Bank Assistance Transactions

Benefits

- *OBA may represent the most cost-effective method for resolving a failing institution.*
- *The transaction can minimize disruption to the local community.*
- *Investors assume some of the risk and bring new capital into the institution.*
- *Assets are kept in the private sector.*

Other Considerations

- *Contingent liabilities remain with the troubled institution.*
- *Also protects customers with uninsured deposits and general creditors, promoting a belief in "Too Big to Fail."*
- *Time necessary for a troubled institution to put together an assistance proposal is sometimes outside the FDIC's parameters for resolving failing institutions.*