CHAPTER 6 – OTHER RESOLUTION ALTERNATIVES

In addition to the three basic resolution methods (purchase and assumption transactions, deposit payoffs, and open bank assistance transactions), other resolution methods were used by the Federal Deposit Insurance Corporation (FDIC), the Federal Home Loan Bank Board (FHLBB), and the Federal Savings and Loan Insurance Corporation (FSLIC). These alternatives were used primarily in the 1980s in response to the increasing problems facing the banking and thrift industries. These methods may provide other countries with some alternative resolution options. All of these methods would fit under the general description of forbearance, which is defined as the act of refraining from enforcement of regulatory action. As a result of changes in U.S. banking laws in the early 1990s, there are very limited circumstances in which the FDIC can use forbearance. Most forbearance programs come at the behest of the U.S. Congress.

Forbearance is a controversial concept. One view is that it should never be used. Proponents of this view look at the high cost to taxpayers from the savings and loan crisis. In large part, those costs were a direct result of delayed action. Another view is that the prudent use of forbearance can be an effective tool in an economic crisis. The responses to the FDIC savings bank problems and the agricultural crisis of the early 1980s are cited as cases in point. Under this view, forbearance can be considered in certain circumstances but should be carefully structured if used. In order to qualify for forbearance programs, institutions should be well managed and have reasonable chances of survival. Once relief has been granted, regulatory authorities should closely monitor the situations and end the forbearance program if the situation deteriorates beyond some predetermined point. Forbearance can take many forms and can provide flexibility in resolving problem institutions, but there must be effective governmental oversight controls.

Net Worth Certificate Program

In 1982, the U.S. Congress established a program that allowed banks and thrifts to apply for capital assistance. Deposit rate structures for banks and thrifts, which had been legally restricted for decades, were deregulated. Financial institutions were required to compete for deposit funds in an inflationary setting, which caused interest rates to sharply increase. Institutions that had primarily lent funds on a long-term basis, such as for 30-year fixed-rate mortgages or long-term government bonds, suddenly had to pay higher rates for deposits to meet their liquidity needs.

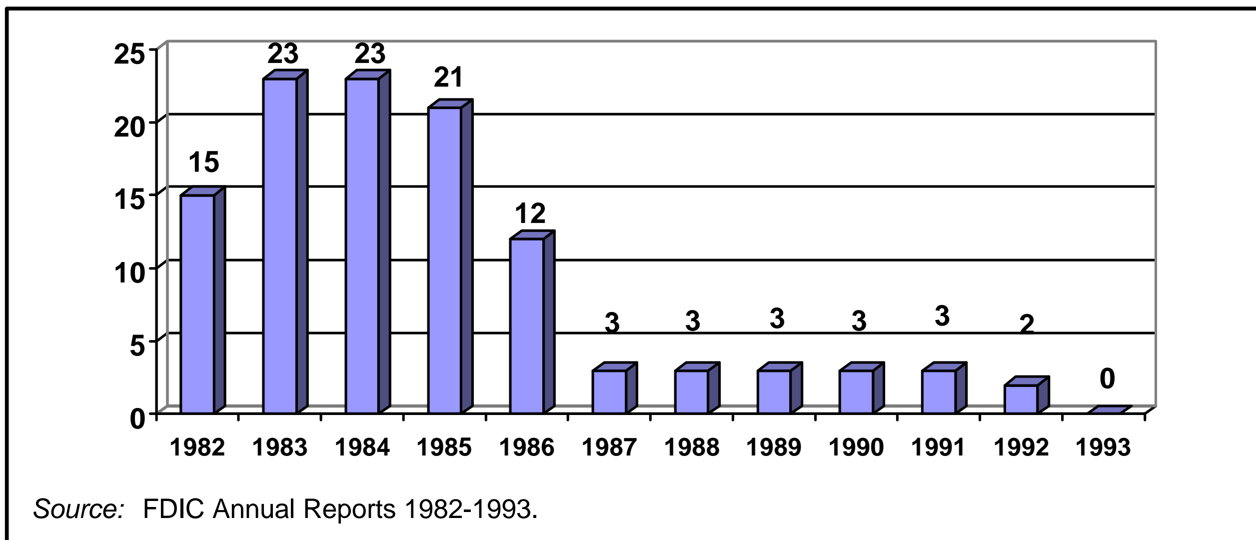
The primary purpose of the Net Worth Certificate Program was to provide capital forbearance to institutions that were not performing well in the new, competitive, deregulated environment. The FDIC's program was restricted to institutions with insufficient net worths; that had recurring losses that were not caused by mismanagement; that would agree to establishing a comprehensive, goal-oriented business plan; and that would consider reasonable merger opportunities. The FDIC "bought" net worth certificates (NWC) from participating institutions in exchange for FDIC promissory notes with terms (such as interest rate, amount, and maturity) identical to those of the net worth certificates. In other words, no cash changed hands. The

NWCs were considered capital for regulatory purposes, but they did not qualify as capital under generally accepted accounting principles (GAAP).

The NWCs were a temporary form of capital that the institution gradually replaced as it became profitable. Institutions were required to reduce the certificates by one-third of their net operating income each year, and the FDIC could request full payment after seven years. The FDIC constantly monitored banks participating in the program. The FSLIC had a similar program for the thrifts. Charts 6-1 and 6-2 show the number of institutions and volume of assets that were involved in the FDIC's Net Worth Certificate Program by year.

Chart 6-1

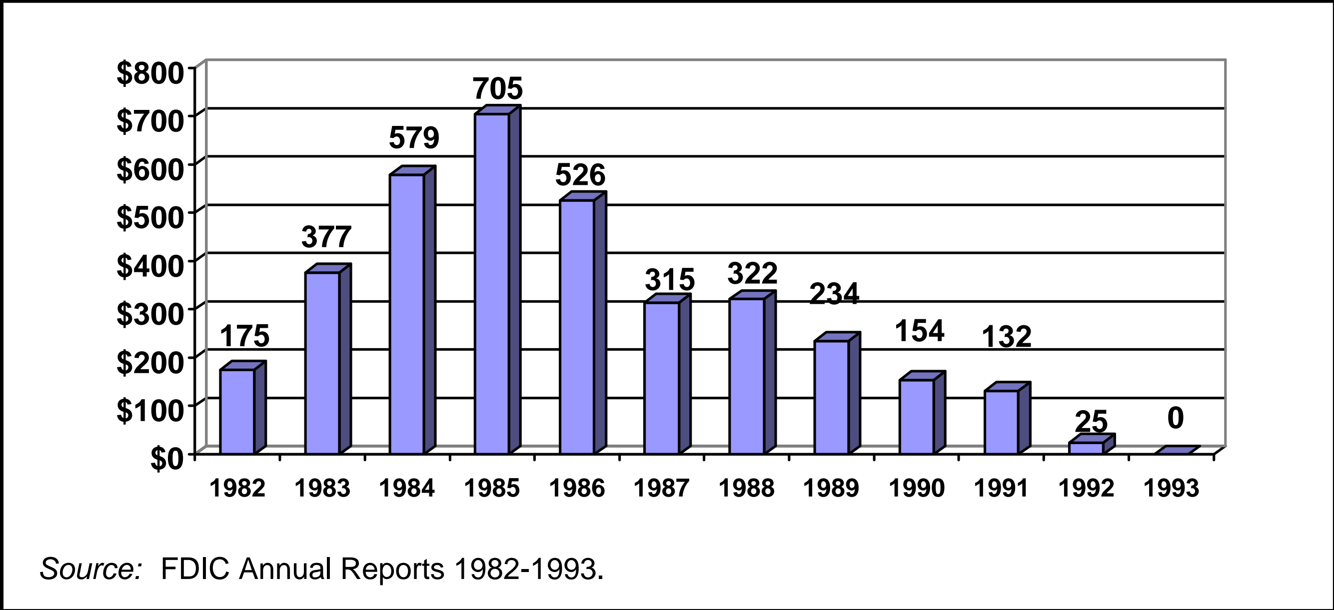
FDIC Net Worth Certificate Program
Number of Banks in Program
1982-1993



Source: FDIC Annual Reports 1982-1993.

Chart 6-2

FDIC Net Worth Certificate Program
Dollars in Program
1982-1993
($ in Millions)



Source: FDIC Annual Reports 1982-1993.

Overall, 29 savings banks with total assets of approximately $40 billion received aid from the program. Of the 29 savings banks participating in the plan, 22 required no further assistance and eventually paid off their NWCs. The remaining seven institutions required additional assistance and cost the FDIC approximately $480 million. Of those seven, four repaid all assistance, and three were merged into healthy institutions with FDIC assistance. Two institutions failed after paying off their NWCs. Those two failures were the result of actions taken by management after they left the NWC program. Table 6-1 below shows the effect of NWCs on an institution's balance sheet.

Table 6-1

An Example of How Net Worth Certificates Affect a Financial Institution's Balance Sheet

Prior to Net Worth Certificates				After Net Worth Certificates			
Assets		Liabilities		Assets		Liabilities	
Loans	800	Deposits	1,000	Loans	800	Deposits	1,000
Other Assets	200	Other Liab.	50	Other Assets	200	Other Liab.	50
				NWC	100		
		Total Liabilities	1,050			Total Liabilities	1,050
						NWC	100
		Capital	-50			Capital	-50
						Total Capital	50
Total Assets	1,000	Total Liab. & Capital	1,000	Total Assets	1,100	Total Liab. & Capital	1,100
		Capital/Assets Ratio	-5.00%			Capital/Assets Ratio	4.55%

Income Maintenance Agreements

From 1981 through 1983, the FDIC used income maintenance agreements to adjust for the effect that the deregulation of interest rates was having on some of its larger savings banks. Those institutions' income was primarily tied to low-yielding, single-family, long-term mortgage loans. The credit quality of the collateral supporting the loans was not a problem.

A major concern to the FDIC was how to resolve those failing savings banks without incurring enormous losses to the insurance fund. The FDIC's resolution strategy was to force the weaker savings banks to merge into healthier banks or thrifts. In order to attract a merger partner, the FDIC guaranteed a market rate of return on the acquired assets through the use of an income maintenance agreement. The FDIC paid a merger partner (the assuming institution) the difference between the yield on acquired earning assets and the average cost of funds for savings banks, plus a "spread" to cover administrative and overhead expenses related to those assets. In effect, the FDIC guaranteed the acquirer a market rate of return on acquired assets with below-market rates. The FDIC entered into these agreements only if the resulting institutions would be viable. In most cases the senior officials at the troubled institution were required to resign, and subordinated debtholders received only a portion of their investments. There are no shareholders in mutual savings banks, so the issue of an unexpected windfall gain for existing shareholders did not need to be addressed.

The FDIC took some risks in issuing net worth certificates and income maintenance agreements and in allowing the institutions to continue to operate. The savings banks were large institutions,

and continued depreciation in their loan portfolios would have had a significant effect on the insurance fund if they had failed. The FDIC reduced its risk by preparing the institutions for mergers or by allowing them time to gradually adjust their asset mixes to more profitable structures. Also, the problem for the savings banks was not tied to collateral values but rather the result of the major change of banking deregulation in the country.

Capital Forbearance Program and Loan Loss Amortization Program

In the early 1980s, the U.S. agricultural economy was in trouble. In 1983, 37 percent of the banks on the FDIC Problem Bank List (a list of banks that could potentially fail) were considered agricultural banks. Over the years, farmers had taken on large sums of debt supported by the rapidly increasing collateral value of their land. As farm income reached a point where it could not support payments on those debts, the loans started to become delinquent. Collapsing land values compounded the problem. Many borrowers' loans had been based on the equity in their land, and that equity had disappeared. Since the borrowers had no way to repay their notes, the banks had no alternative but to begin foreclosure to try to recover at least a portion of their funds. The many foreclosures tended to push land values even lower because as the bank's owned real estate portfolios grew, banks were forced to sell those nonearning assets as quickly as possible. Large numbers of farm foreclosures were quickly followed by large numbers of bank failures in states where the economy depended on agriculture.

As large numbers of agricultural banks failed in the 1980s, methods were developed to save institutions that were historically well-managed but financially troubled as a result of the depressed economy in their areas. The FDIC instituted two programs that were called the Capital Forbearance Program and the Loan Loss Amortization Program.

The Capital Forbearance Program allowed well-managed, economically sound institutions with concentrations of 25 percent or more in agricultural or energy loans to be temporarily exempt from regulatory capital requirements. Eligible banks were required to have a capital ratio of at least 4 percent, and their weakened capital position had to be a result of external problems in the economy and not a result of mismanagement, excessive operating expenses, or excessive dividends.

The Loan Loss Amortization Program allowed banks to amortize agricultural losses on their books over a seven-year period. Only institutions of less than $100 million in total assets and with at least 25 percent of their total loans in agricultural credits were eligible for this program. Qualified institutions were judged to be economically viable and fundamentally sound, except for needing additional capital to carry the weak agricultural credits.

A total of 301 institutions participated in the Capital Forbearance Program, and an additional 33 were in the Loan Loss Amortization Program. Although most of those institutions were either insolvent or close to being insolvent, only 21 percent of those institutions subsequently failed. Table 6-2 shows the distribution of banks among the two programs.

Table 6-2

Results of the Capital Forbearance Programs*
Agricultural and Energy Sector Banks

	Capital Forbearance Program	**Loan Loss Amortization Program**
Number of Banks in Program	301	33
Assets of Banks in Program ($ in Billions)	$13.0	$0.5
Avg. Size of Banks in Program ($ in Millions)	$43.2	$15.2
Number of Banks that Survived**	236	29
Number of Banks that Failed	65	4

*Banks that participated in both programs are included only in the Capital Forbearance Program.

**Banks that left the program as independent institutions or were merged without assistance.

Source: FDIC Division of Research and Statistics.

There are many risks in offering forbearance programs, but carefully managed forbearance programs have been used successfully to prevent institution failures. In both the Capital Forbearance Program and the Loan Loss Amortization Program, the participating banks were primarily small institutions that served farm communities. The farm crisis was temporary, and these methods of forbearance allowed banks the time to recover. The risk to the insurance fund was minimal because the banks were small and easily identifiable. The effects on the insurance fund would have been much larger if the farm crisis had continued indefinitely, if the losses had not been recognized early, or if the value of the collateral had continued to erode.

Resolution of Savings & Loan Associations Prior to FIRREA

In response to the increasing problems facing the thrift industry, the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation used the following resolution methods.

Easing of Capital Requirements

The cause of failure of most thrifts in the early 1980s was the economic issues faced by the entire industry. The mismatch between the rates generated by the long-term assets (mostly mortgage loans) held by thrifts and the shorter-term liabilities used to fund those assets created what is commonly referred to as a “spread problem.” The FHLBB pursued strategies to keep those

"spread problem thrifts" open until rates returned to lower, more traditional levels. The FHLBB's first strategy in response to the developing thrift crisis was a general easing of the thrift industry's capital requirements which was accomplished by the following methods.

Lower Capital Requirements. In the early 1980s, the FHLBB lowered thrift capital requirements from 5 percent of liabilities to 3 percent of liabilities.

Deferred Loan Losses. Thrifts were able to amortize certain loan losses attributable to the rise in interest rates over an extended period of time.

Appraised Equity Capital. Thrifts were allowed to report the value of owned premises at the current market value instead of at the typically lower historical value.

Averaging of Liabilities. Thrift capitalization allowed for five-year averaging of liabilities. Although this capital requirement had been in place long before the thrift crisis, it had the unintended effect in the mid-1980s of allowing aggressive thrifts to grow without a commensurate infusion of capital. That lack of capitalization in conjunction with more lending and investment freedom resulted in increased risk to the FSLIC insurance fund.

Easing capital requirements can be a useful tool in allowing financial institutions to remain open through temporary periods of operating difficulties. A very diligent examination and supervision function must be maintained to ensure that institutions with capital problems continue to be managed in a prudent manner. In institutions where poor management becomes an issue, corrective action must be taken promptly to bring management under control.

Use of Mergers and Acquisitions

In cases where thrifts failed even with the easing of capital requirements, the FHLBB encouraged mergers between thrifts. The FHLBB used mergers and acquisitions as resolution tools throughout its history. There were two types of mergers and acquisitions: unassisted and assisted.[1]

The FSLIC did not have the cash resources to liquidate what would have been a large percentage of the industry. Mergers and acquisitions were methods of managing the FSLIC's limited resources. Whether a failing thrift was resolved with or without FSLIC assistance depended on a number of factors, including the extent of the thrift's problems, the types of asset problems in the institution, and the perceived market value of the franchise.

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[1] In the unassisted merger, supervisory authorities would encourage a weak thrift to merge with a healthier thrift, with no direct financial assistance from the FSLIC. In an assisted merger, an acquirer would assume all (or nearly all) the assets and liabilities of a failed thrift and would receive assistance from FSLIC. The assisted merger was the most popular form of FSLIC resolution since it deferred FSLIC cash payments.

Unassisted Mergers. The FHLBB encouraged mergers between failing mutually owned thrifts and other, healthier, mutually owned thrifts *without FSLIC assistance.* In those mergers, favorable accounting rules allowed the acquirer to count the losses in the acquired thrift's assets as goodwill that could be amortized over a relatively long period of time. In instances where GAAP did not allow for that treatment, the FHLBB allowed the acquiring thrift to report increased capital for regulatory purposes and to amortize the goodwill over a longer period of time than was allowed under GAAP. The majority of those mergers occurred in the early 1980s before many credit problems appeared.

Assisted Mergers and Acquisitions. When an unassisted merger could not be arranged, the FSLIC marketed the failing thrift with the offer of direct FSLIC financial assistance to the acquirer. When a failing thrift was mutually owned, there were no windfalls for stockholders. When stockholders owned a failing thrift, the FSLIC resolved the failing institution with an assisted, whole institution purchase and assumption transaction. Claims of existing shareholders were left with the receiver of the failed institution.

Like the FDIC, the FSLIC used income maintenance and net worth certificates for simple spread problem thrifts in the early 1980s. The FSLIC also provided acquirers with capital assistance by purchasing income capital certificates (ICC), which were similar to cumulative preferred stock.[2] That capital assistance helped reduce the direct FSLIC assistance payment, and the acquirer was provided with the regulatory capital needed to grow so that it could absorb any losses in the portfolio of acquired assets.

In the mid- to late-1980s, the problems seen at failing thrifts resulted from poor or speculative management decisions that created asset "credit quality" issues. Credit quality problems, coupled with the FSLIC's lack of liquidity, made it necessary for the FSLIC to enter into longer-term assistance agreements with acquirers. Those agreements minimized the FSLIC's immediate outlay of cash. If an acquirer took title to all of a failing thrift's assets, the FSLIC agreed to make periodic assistance payments that covered the costs of holding and disposing of the assets. The FSLIC also gave cash or notes equal to the negative net worth on the books of a failing institution and made periodic payments for income maintenance and loss reimbursement.

Assistance agreements can be useful in the resolution process especially when the preservation of liquidity is important and staff is limited. Because the insurance fund continues to bear credit risk, it is important that an acquirer's staff has sufficient asset management expertise and agreements are structured so that the acquirers' interests and incentives are aligned with those of the insurer. This means that the acquirer shares in the losses (and gains) of the portfolio of

[2] Income capital certificates were used as a form of noncash FSLIC assistance. A troubled thrift would issue an ICC to the FSLIC in exchange for a FSLIC note. The FSLIC note was an asset on the thrift's books with the offsetting liability (ICC) counting as regulatory capital. If the thrift had earnings and had achieved a certain level of net worth, it paid a portion of its net income to the FSLIC in the form of interest (dividends) based on a variable rate. The FSLIC generally paid interest on the note to the institution in cash. The ICC program was in effect from 1981 through 1986.

acquired assets. It is equally important to carefully monitor and oversee the acquirer's management of the assets covered under the agreement.

Use of Tax Incentives in Assisted Transactions

In response to continuing concerns regarding the solvency of the FSLIC, in 1981 the U.S. Congress passed legislation that allowed FSLIC assistance payments to accrue tax-free to acquiring institutions. The tax benefits were intended to reduce the cash assistance required for the FSLIC to complete acquisitions of failed institutions. The FSLIC did achieve cost savings, but it did not always receive a dollar-for-dollar reduction in the cost of assisted transactions.

Merging poorly performing institutions with healthy institutions can be beneficial to an insurer. Healthy banks or thrifts may have better management, there may be cost savings achieved in the operations area, and there may be a reduction in the number of open competing institutions that may allow the survivors to be more profitable. On the other hand, mergers may delay problems and result in much larger institution failures. The FSLIC's extensive use of forbearance was a result of an inadequate insurance fund in an industry in which many institutions were insolvent. This eventually led to FSLIC's insolvency and demise. However, the FSLIC programs may be effective in more limited situations, if used with care.

Management Control

In addition to the various forbearance programs mentioned above, the FHLBB also used an additional noncash resource to attempt to resolve the thrift crisis. In 1985, in response to the heavy pace of failures and the lack of FSLIC funding, the FHLBB initiated the Management Consignment Program (MCP) to immediately address management control. The MCP was, in effect, a conservatorship program and addressed the FSLIC's lack of staff resources needed to immediately close failing institutions. Under the MCP, new management was brought in to manage troubled institutions; the FHLBB indemnified managers in the MCP. Institutions being managed under the FSLIC's MCP when the Resolution Trust Corporation (RTC) was created became the initial RTC conservatorship caseload. Insurance funds that are strapped for cash might use this method as a temporary means to share industry expertise to stabilize a situation.