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Statement by the

Shadow Financial Regulatory Committee

on

Aid to Failing Banks

February 14, 1986

The Comptroller of the Currency has recently proposed that failing agricultural banks be kept in operation by a combination of deferral of losses and direct financial assistance from the FDIC. We oppose unrealistic deferral of losses, but FDIC assistance may be an appropriate alternative to liquidating the bank or merging it into a healthy institution. Such an approach has merit when a turnaround of the institution appears possible and provided that it imposes appropriate penalties on stockholders, management and uninsured depositors and other creditors. The FDIC should obtain an equity position in the bank that will allow it to recapture its outlay through sale of that equity if the bank becomes a viable entity.

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FDIC assistance endorsed to save failing banks

The newly formed Shadow Financial Regulatory Committee (SFRC), meeting February 14 in Washington, D.C., concluded that a recent Comptroller of the Currency proposal to save failing agricultural banks by a combination of deferral of losses and direct financial assistance from the FDIC has merit. "We oppose unrealistic deferral of losses," said the group in a policy statement released after the meeting, "but FDIC assistance may be an appropriate alternative to liquidating the bank or merging it into a healthy institution."

"Use of this technique should be considered carefully," said Paul Horvitz, SFRC member and professor of banking and finance at the University of Houston. "It should not be a means of keeping alive institutions purely on the basis of political ramifications of closing banks in farm states."

According to the SFRC policy statement, "Such an approach has merit when a turnaround of the institution appears possible and provided that it imposes appropriate penalties on stockholders, management and uninsured depositors and other creditors." The group opposed loss deferrals that cloak the true condition of financial institutions and hinder timely and effective regulatory responses to problem situations.

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"The FDIC should obtain an equity position in the bank that will allow it to recapture its outlay through sale of that equity if the bank becomes a viable entity," the group concluded.

The Shadow Financial Regulatory Committee is a private sector group of 13 leading academic experts and former regulators formed to monitor regulation of the financial services industry from a market perspective. The sponsors of the committee are Mid America Institute for Public Policy Research, Chicago; Foundation for Financial Institutions Research of Bank Administration Institute, Chicago; The University of Michigan, and The University of North Carolina.

Attachments: SFRC policy statement and background paper by Paul Horvitz, Judge James Elkins Professor of Banking and finance at the University of Houston

Paul Horvitz
For Feb 14 Meeting
of FIRAG

HANDLING FAILED BANKS

There are several alternative means that can be used by FDIC and FSLIC for handling bank failures, and several criteria that are important in deciding among the alternatives.

When a bank is about to fail, the FDIC can simply pay off the insured depositors and liquidate the assets. Alternatively, it can arrange a transaction whereby, with FDIC financial assistance, a healthy bank purchases the assets and assumes the liabilities of the failed bank or the FDIC can provide direct financial assistance to the troubled bank to allow it to stay in operation. The latter type of transactions provide full protection to all creditors, and not just insured depositors. It is possible to develop hybrid approaches, such as the "modified payoff" in which another bank assumes the insured deposit liabilities of the failed bank plus a fraction of the uninsured deposits. It is also possible to develop a "trusteeship" form of direct assistance in which the FDIC takes over direction of the bank (as in Continental Illinois, for example) and imposes a loss or "haircut" on uninsured depositors based on the FDIC's expection of its ultimate loss. (The FSLIC is now regularly taking over management of insolvent S&L's but, as in Continental, without imposing a loss on large depositors).

The criteria are easy to enumerate and to accept in principle. The difficulty is in resolving conflicts among the criteria.

1. Insured depositors must be paid the amount of their

deposit up to the insurance limit ($100,000). This is, of course, the most important consideration and, regardless of the method chosen, this condition must be met.

2. Minimize cost. Like a commercial insurance company, the FDIC seeks the least cost solution. In some cases the FDI Act may specify that consideration, but prudent management would generally call for minimizing cost. "Least cost" would generally be interpreted to mean the outlay with the lowest net present value. It is clear that FSLIC is now more concerned with minimizing current period cash outlays or commitments that must be recognized as a cost in current financial reports. This is due, obviously, to the current strained state of FSLIC finances.

3. Minimize disruption of the financial system or the risk of financial panic. At times the insurance agencies may opt for a more costly solution because of fear that the least cost solution will lead to instability. Rather than paying off insured depositors and liquidating the bank, the FDIC may provide direct assistance to a large bank to keep it in operation, or the FDIC may assist a healthy bank with acquisition of the failing bank. These latter alternatives provide protection to all creditors of the failing bank, and not just insured depositors. Such transactions may be, but are not necessarily, more costly to FDIC than payoff and liquidation. In particular, the P&A is usually the least cost solution because the acquirer is willing to pay a premium for the franchise value of the failed bank.

No very large bank failure has ever been handled through the

payoff of insured depositors (Penn Square, with $500 million of deposits is the largest to be paid off). There is evidence that the regulatory agencies overemphasize the risk of financial panic and systemic runs on banks. Bank runs have rarely if ever lead to the failure of a sound bank, and the Federal Reserve has ample power to prevent bank runs from resulting in a decline in aggregate bank reserves. Obviously, however, the cost of erroneously concluding that a particular policy action will <u>not</u> result in financial panic is very large.

It is this bias in favor of protecting all creditors of large banks that leads to the conclusion that some banks are "too large to fail." Correctly defined, no bank is too large to fail, though some may be too large to be paid off and liquidated.

4. Those responsible for causing a bank to fail should not be protected. Specifically, this means that even if direct assistance allows the bank to continue in operation, top management, and others directly responsible for the failure, should be removed (preferably without valuable pension benefits). Further, stockholders should be wiped out before FDIC incurs a loss.

5. Minimize impact on the structure of the financial system. Although the Garn-St Germain Act allows interstate acquisitions in case of failure, and acquisitions of thrift institutions by commercial banks (or vice versa), it is clear that these approaches are to be used only when the traditional within-state, within-industry approach is not workable.

6. Failures should be handled in a manner that encourages the development of market discipline. If uninsured depositors lose when a bank fails, they will have an incentive to choose their bank on the basis of its soundness and conservative operation. That is the reason deposit insurance in the U.S. has always been less than 100%. The use of P&A transactions (usually the least cost means of resolving failure) tends to preclude the development of market discipline. While FDIC has often paid lip-service to this criterion, and the development of the "modified payoff" is in response to this consideration, when failures of large banks threaten, this criterion (and the following one) seem to rank lower in the FDIC's priorities.

7. Banks should be treated similarly, regardless of size. If depositors in large banks receive greater protection than depositors in small banks, the end result will be a tendency toward greater concentration of banking resources and unequal competition between large and small banks.

IMPLICATIONS FOR POLICY

It is clear that these criteria are frequently in conflict. The P&A is usually the cheapest approach, but the general use of that approach tends to break down market discipline. When FDIC fears financial panic, prevention is the overriding consideration. It is difficult to be critical of FDIC decision-making in this area, except that there seems to be an exaggerated fear of creating instability if a large bank failure should result in loss to uninsured depositors. The modified payoff seems a step

in the direction of greater equity and improved market discipline, but FDIC staff do not believe it is feasible in very large failures. The principal area of controversy in decisions by the insurance agencies appears to be in the use of direct assistance.

The FDIC uses direct assistance only in the case of large bank failures. We believe that the "trusteeship" approach with a haircut to uninsured depositors is more equitable and more conducive to the development of market discipline than assistance that protects all creditors.

FSLIC has made considerable use of direct assistance in its "management consignment program," whereby failed institutions are put into a receivership, with assets and liabilities assumed by a newly chartered institution. The new institution is run by a board of directors appointed by FSLIC, and management is supplied by another institution (which signs a contract with FSLIC). In these cases, all liabilities are assumed, but the receivership may be a means of imposing a haircut if FDIC were to copy that approach (few failing S&Ls have significant uninsured deposits).

FSLIC has adopted this approach as a means of minimizing cash outlays. The approach has a significant disadvantage in that the insolvent institutions continue to operate with FSLIC guarantees, and must pay above-market rates to maintain their deposit base. This tends to bid up interest rates above what would prevail in a private, competitive market--in a free market those paying rates that are too high would go out of business.

Direct assistance is not necessarily poor policy, as long as

those responsible for failure, and stockholders, are not protected. In particular, the Comptroller has recently suggested increased use of this approach for smaller banks, presumably agricultural banks where economic forces and not deliberate wrong doing seem to be the cause of the failure. Use of this technique should be considered carefully. It should not be a means of keeping alive institutions purely on the basis of political ramifications of closing banks in farm states. The evidence so far suggests that failures of such banks have been associated with imprudent lending and lack of diversification. Most banks in agricultural areas are sound. Even if failure is due in part to general economic considerations, FDIC assistance should be accompanied by the dismissal of top management. FDIC assistance should not protect stockholders, even if uninsured depositors are protected.

Paul M. Horvitz
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