

A REVIEW OF THE FDIC'S LATEST TOOLS FOR RESOLVING PROBLEM BANKS

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The challenges before the Federal Deposit Insurance Corporation (FDIC) can hardly be overstated. A storm of bank and thrift problems has gathered, a deluge of institution failures has befallen the FDIC, and the downpour promises only to intensify. This article provides an overview of the issues the FDIC faces as conservator or receiver for the nation's banks and thrifts, and the tools it has deployed to date or is likely to consider, on a case-by case and industry-wide basis, to deal with the deepening global economic woes.

As history and experience have taught us, little notice is taken during good times of economic storm clouds as they begin to form. The origin of the storm this time was the overleveraging of America, fostered by the benevolent nudging of government to make home ownership affordable and sustained by the desire at every wrung in the socioeconomic ladder to profit from doing so, whether or not the home buyer could afford his aspirations. As we also have learned, banks mirror the economy, and, when the economy is hurting, so are banks. It is no surprise, therefore, that banks in increasing numbers become undercapitalized or insolvent during hard times. It would be unprecedented if it did not happen. The issue for banking regulators in hard times is how to help patch together banks' balance sheets torn by the economic storms and help most of them to survive until normal conditions return, as they always do. The other side of the proposition is to identify the banks that cannot survive until normality returns, and to resolve them in the least costly and most efficient manner possible. The latter job is the FDIC's responsibility.

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One need not look back far to recall much sunnier U.S. banking conditions (at least on the surface). From June 25, 2004 until February 2, 2007, not a single bank or thrift failed, the longest period without a banking failure since the FDIC was created in 1933.¹ Even then, the second bank failure of 2007 did not occur for almost eight months, and only three failures occurred during the year. The amount of assets that the FDIC was called on to manage and sell was correspondingly small, and the FDIC was able to handle those assets using procedures that it had fashioned largely in the period of relative calm following the massive bank and thrift failures of the late 1980s and early 1990s. A reduced resolutions and receiverships staff, in coordination with other banking regulators, could anticipate and prepare for possible closings well in advance of the event, rely on staff resources to locate healthy depository institutions interested in bidding on failing institutions, and dispose of the assets of failed institutions fairly quickly using the new tools of the internet—digital document rooms, remote due diligence, and electronic submission of bids.

Fast forward to 2008, when 25 institutions failed, and open bank assistance was authorized for five more (as part of a planned rescue that did not occur). Four institutions closed in the first six months of the year, ten institutions closed in the next three months, and 12 closed in the final three months.² One institution, on account of the suddenness of its decline, was closed mid-week, instead of at the end of the business week as ordinarily occurs.³ In the first two months of 2009, 16 more institutions closed.⁴ The FDIC retained assets from closed institutions of approximately \$1.2 billion in 2007, approximately \$1.9 billion in the first six months of 2008, approximately \$39.6 billion in the next three months, and \$6.8 billion in the final three months.⁵

¹ *Failure of Pa. Bank is FDIC's First Since '04*, American Banker (Feb. 5, 2007).

² *Quarterly Banking Profile, Fourth Quarter 2008*, FDIC (Feb. 26, 2009).

³ *JPMorgan Chase Acquires Banking Operations of Washington Mutual*, FDIC PR-85-2008 (Sep. 25, 2008).

⁴ *Banks Closed in Nevada and Illinois*, FDIC Says, MarketWatch (Feb. 28, 2009).

⁵ The FDIC avoided dealing with much larger volumes of assets. On September 25, 2008, JPMorgan Chase Bank, N.A., purchased from the FDIC substantially all the assets, totaling approximately \$307 billion, of Washington Mutual Bank immediately after it was closed by the Office of Thrift Supervision (OTS). *JPMorgan Chase Acquires Banking Operations of Washington Mutual*, FDIC PR-85-2008 (Sep. 25, 2008). On September 29, 2008, the FDIC agreed to enter into a loss sharing arrangement with Citigroup, Inc. in support of its proposed acquisition (which did not occur) of Wachovia Bank, N.A. and four affiliated depository institutions with approximately \$782 billion of assets in the aggregate. *Citigroup Inc. to Acquire Banking Operations of Wachovia*, FDIC PR-88-2008 (Sep. 27, 2008). On October 24, 2008, PNC Corporation agreed to acquire National City Corporation, including National City Bank with assets totaling

The FDIC has estimated that the cost to the Deposit Insurance Fund (DIF) of closings from 2007 through January 2009 will be between \$12.2 billion and \$17.1 billion. During 2008, the DIF dropped from \$52.4 billion to \$18.9 billion, or from 1.22% to 0.40% of all insured deposits, while the number of institutions on the FDIC's watch list increased from 76 institutions with \$22 billion of assets to 252 institutions with \$154 billion of assets, or approximately 1.1% of the total assets of all insured depository institutions.⁶ On October 7, 2008, the FDIC adopted a restoration plan to raise the DIF to 1.15% of insured deposits within five years, as required by law, in the process roughly doubling the assessments of most of the nation's banks and thrifts to between 12 and 14 basis points.⁷ On February 27, 2009, in the face of deteriorating conditions, the FDIC raised the assessment for most institutions to between 12 and 16 basis points, imposed a special assessment of 20 basis points, and extended the timetable for restoring the DIF from five years to seven years.⁸

In these challenging times, the FDIC has shown great flexibility and creativity in addressing the situation, notwithstanding that, in the past, such efforts by other banking regulators have been strongly criticized.⁹

The FDIC's obligation is to resolve a bank or thrift receivership at the least cost to the DIF.¹⁰ However, this requirement permits several methods of resolution. A "whole bank" resolution, in which a purchaser acquires all or substantially all the assets and liabilities of a

approximately \$142 billion, relying in part on assistance of approximately \$7.7 billion provided by the Department of the Treasury through its Capital Purchase Program to finance the transaction. *PNC Gets National City in Latest Bank Acquisition*, The New York Times (Oct. 25, 2008).

⁶ *Quarterly Banking Profile, Fourth Quarter 2008*, FDIC (Feb. 26, 2009). In addition, some of the largest failures during 2008, including IndyMac Bank, were not on the watch list when they failed. *Experts: More Failures Likely But Not on IndyMac Scale*, San Diego Union-Tribune (Aug. 10, 2008).

⁷ *Risk Based Assessments*, 73 Fed. Reg. 78155 (Dec. 22, 2008).

⁸ *FDIC Extends Restoration Plan; Imposes Special Assessment*, FDIC PR-30-2009 (Feb. 27, 2009). On March 5, 2009, FDIC Chairman Sheila Bair announced that the special assessment would be reduced to ten basis points if the FDIC's borrowing authority from the Department of the Treasury was increased. *FDIC to Slash Special Fee*, American Banker (Mar. 6, 2009).

⁹ Loss sharing, asset participations, and joint ventures now being used by the FDIC to dispose of failed banks and their assets, as discussed below, were used with great frequency in the 1980s by the Federal Savings and Loan Insurance Corporation (FSLIC), which was confronted with more than 4,000 failing savings institutions and a liquid insurance fund of only about \$3 billion. Many of the actions taken by the FSLIC then were criticized by the Congress, commentators, and even the FDIC.

¹⁰ Federal Deposit Insurance Corporation Improvement Act, Pub. L. No. 102-242, 105 Stat. 2236, § 141 (1991) (codified at 12 U.S.C. § 1823(c)(4)).

failed bank, typically with some financial assistance, often may be least costly to the DIF, because it does not require the FDIC to pay off any depositors, to provide large amounts of cash to a purchaser uninterested in acquiring the failed institution's assets, or to administer those unwanted (and often impaired) assets. More often, a purchaser will agree to purchase only the most reliable or useful assets of a failed institution, such as cash, Treasury securities, and retail branch offices. This leaves the FDIC with the problem of managing the failed institution's bad loans, illiquid investments, and foreclosed property and attempting to realize the greatest value from them through collection efforts or sales.¹¹ Retained assets may pose unique challenges based on the complexity of the failed institution's servicing and other outsourcing arrangements, securitization and recourse obligations, use of derivatives and other financial contracts, and internet operations. A secondary goal of the FDIC is to find a depository institution willing to assume all the deposits of a failed bank, both insured and uninsured, in order to provide all depositors with uninterrupted access to their funds, avoid confusion among depositors and potentially unfavorable publicity regarding depositors' difficulties, and eliminates the expense, including cash requirements, and administrative costs of "paying out" insured depositors.¹² Frequently, however, a buyer is uninterested in acquiring brokered deposits, which are typically higher-cost and less stable than "core" retail deposits. Typically, at the time a bank or thrift is closed, the FDIC reaches an agreement with only a single bidder, and it is left to deal with all the assets and deposits that the bidder does not want.¹³

The recent cost of resolutions using the methods described above has been high. For all receiverships during the first two months of 2009, the estimated cost is 23% of the failed institutions' total assets. During 2008, for all receiverships other than the failure of Washington Mutual Bank, the estimated cost is 25%. By comparison, from 1990 through 2007, the average cost was approximately 14%.¹⁴ The FDIC, which had an

¹¹ From 2007 through February 2009, of the 44 institutions closed, nine were whole bank resolutions, all but one of which were based on a loss sharing arrangement to cover a large portion of the failed bank's assets. The FDIC retained the large majority of assets in the remainder of the cases. The five institutions approved for open bank assistance also constituted whole bank resolutions.

¹² *FDIC Defends Handling of IndyMac Run*, American Banker (July 18, 2008).

¹³ Direct assistance to a failing bank or thrift before it is closed is not an option under ordinary circumstances. See 12 U.S.C. § 1823(c)(4)(G) and (c)(8).

¹⁴ *FDIC Premium Rule Targets Banks' More Costly Funding*, American Banker (Mar. 9, 2009).

authorized resolutions and receiverships staff of 223 at January 1, 2008, has been stretched thin by the increased volume of assets it must handle. It has opened a West Coast branch office for asset management, approved a 684% increase in its 2009 budget for receivership operations over estimated 2008 expenses, and increased its authorized resolutions and receivership staff to 847 permanent and temporary positions.¹⁵ Conservatorships also impose a heavy administrative burden on the FDIC, because they require the FDIC to oversee open bank operations while also working to sell the institution.

Other, broader financial developments also have added to the FDIC's operational burdens. A bank or thrift may face a "liquidity crisis" if it relies, by choice or necessity, to a significant extent on short-term borrowings in capital markets and investors seek to shorten their maturities or become unwilling altogether to roll over their holdings. In such an event, a bank or thrift that appears to be adequately capitalized or well capitalized can collapse in a few days.¹⁶ Banking regulators, including the FDIC, may have little or no time to prepare for a closing caused by a loss of investor confidence and, perhaps even more relevant to the financial health of the DIF, to market the institution prior to closing to qualified and interested bidders who may reduce or eliminate the volume of assets that the FDIC must retain and manage. It may be necessary to place an institution closed by a loss of liquidity into conservatorship, or first into receivership followed by a new charter operating in conservatorship, simply in order to develop a plan to resolve, rather than dissolve, the institution. Conservatorship, as mentioned above, requires substantial administrative resources. It also requires the DIF to stand ready to provide additional liquidity as needed.

The demise of Fannie Mae and Freddie Mac created another failure scenario. Banks and thrifts were encouraged to invest in the preferred stock of these government-sponsored enterprises by exemptions from investment limitations that applied to other equity investments and favorable regulatory capital treatment of their investments.¹⁷ For a few smaller institutions

¹⁵ *FDIC Announces Location of Temporary West Coast Satellite Office*, FDIC PR-119-2008 (Nov. 18, 2008); Attachment 5 to FDIC 2009 approved operating budget, available at www.fdic.gov/news/board/O9Decl5rule5BUDGET.pdf.

¹⁶ *IndyMac Faces Bank "Run"*, Mortgage News Daily (July 9, 2008); *WaMu Is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Bank History*, The Wall Street Journal (Sep. 26, 2008).

¹⁷ See, e.g., 12 U.S.C. § 24(Seventh) (authorizing investment by national banks in "other instruments" issued by Fannie Mae and Freddie Mac); 12 U.S.C. § 1831a(c)(1) (authorizing insured state banks to make equity

that apparently did not maintain a sufficiently diverse investment portfolio, the collapse of the value of Fannie Mae and Freddie Mac preferred stock after they were placed into conservatorship caused a substantial loss of capital. In one instance, this reportedly led to the institution's failure.¹⁸

In these circumstances, the FDIC has sharpened its tools to deal with more numerous, larger, and more complex bank and thrift failures. These actions serve by and large to increase the FDIC's ability to find pre-closing bidders and to encourage bidders to take a larger share of the assets of a failing institution.

- *Shelf charter.* On November 21, 2008, the Office of the Comptroller of the Currency (OCC) announced a program to approve “shelf charters” for national banks.¹⁹ Shelf charters expand the pool of eligible investors for failing institutions. Historically, for a variety of reasons, the FDIC has only permitted insured depository institutions to bid. Others interested in bidding have needed to find a bank or thrift partner that could deal directly with the FDIC; a non-depository entity could invest in its partner or enter into an agreement with its partner as to how the assets and nondeposit liabilities of the failing institution would be owned and managed. A shelf charter, by contrast, constitutes conditional preliminary approval to organize a national bank, and the recipient is qualified on that basis to participate directly in the FDIC bidding process.²⁰ The charter is activated after the organizers are awarded a failing bank by the FDIC and the remaining conditions are satisfied.

investments that are permissible for a national bank); 12 U.S.C. § 1464(c)(1)(D) and (E) (authorizing federal savings associations to invest in securities issued by Fannie Mae and Freddie Mac without limit as a percentage of assets, subject to regulations of the OTS); 12 C.F.R. § 560.30 (OTS regulation setting no limit on investments in securities of government-sponsored enterprises); 12 C.F.R. Part 3, App. A, *Risk-Based Capital Guidelines*, §§ 1(c)(37) and 3(a)(2)(vi) (providing 20% risk weighting for assets issued by U.S. government-sponsored agencies).

¹⁸ *Politicians Asked Feds to Prop Up Ailing Bank*, The Wall Street Journal (Jan. 24, 2009); *Republic Bank of Chicago Acquires All the Deposits of National Bank of Commerce, Berkeley, IL*, FDIC PR-5-2009 (Jan. 16, 2009). However, in this case, the bank was otherwise relatively unimpaired, and the FDIC was able to sell it on a whole bank basis at relatively limited cost to the DIF.

¹⁹ *OCC Conditionally Approves First National Bank "Shelf Charter" to Expand Pool of Qualified Bidders for Troubled Institutions*, OCC NR-2008-137 (Nov. 21, 2008).

²⁰ *FDIC Expands Bidder List for Troubled Institutions*, FDIC PR-127-2008 (Nov. 26, 2008).

The requirements for a shelf charter, however, are rigorous. The OCC evaluates the qualifications of the proposed management team for the bank in organization, the proposed ownership structure, the sources and amounts of capital available, the overall strategic plan, and a streamlined business plan.²¹ The organizers also must apply to the FDIC for deposit insurance and to the Board of Governors of the Federal Reserve System (FRB) if they desire to form a bank holding company.²² Before the bank may open, it is required to submit a comprehensive long-term business plan, and it and its organizers may even be required to enter into an Operating Agreement with the OCC.²³ A shelf charter, therefore, is not an avenue for all interested parties, but it provides an opportunity for dedicated and well-prepared investors to gain access to the FDIC pre-closing bidding process, and to have access to a depository institution and its better assets before it is potentially chopped up into less desirable pieces.²⁴

- *Consortium bidding.* In the late 1980s and early 1990s, in a few instances, the FDIC and the Federal Home Loan Bank Board (FHLBB) sold a failed institution to a consortium of private equity investors.²⁵ On December 31, 2008, the FDIC revived this model when it signed

²¹ OCC Conditional Preliminary Approval Letter for the establishment of Ford Group Bank, N.A. (Nov. 17, 2008) (the “OCC Conditional Preliminary Approval Letter”). Experienced and capable management that is well known to banking regulators is a key element of the application. For this reason, the organizers need to obtain firm commitments from the senior officers to ensure their availability, even though the organizers may not win the bidding for a failing institution for several months.

²² The FRB has not adopted a comparable “shelf charter” program for bank holding companies. Private equity groups that are part of the ownership group for a shelf charter may find that FRB approval continues to pose challenges regarding their ability to participate in management.

²³ See OCC Conditional Preliminary Approval Letter. In a somewhat similar situation, in which an investor acquired a small national bank to use as a vehicle for future acquisitions, the Operating Agreement gave the OCC the right to approve a wide variety of plans, operations, and potential changes in the institution. The Operating Agreement also was enforceable as a condition imposed in writing in connection with the grant of an application, pursuant to 12 U.S.C. § 1818(e).

²⁴ The OTS also has been receptive to this concept on a case-by-case basis and is reported to be working on a formal program of its own.

²⁵ In 1988, as part of its “Southwest Plan” to resolve failed and failing savings institutions, the FHLBB sold several institutions, including what was at the time the nation’s largest insolvent savings institution, to private investment groups. *Boom Times for Thrift Doctors*, The New York Times (Sep. 11, 1988) (sale of American Savings and Loans Association of California to a group of investors headed by Robert M. Bass of Fort Worth, Texas); *Prudential Would Put Up \$50MM in Consolidation of Texas Thrifts*, National Mortgage News (June 27, 1988); *Gibson/LSST Financial Acquires 12 Texas Thrifts; Cleanup Reaches 24*, PR Newswire (Aug. 18, 1988). Additional private investors, including foreign investors, were reportedly interested. *Selling Ailing Texas S&Ls Is Problematic – Regulators Swamped by Varying Buyers, Plans*, The Wall Street Journal (Jan. 19, 1988). In 1991, the FDIC sold New Bank of New England, a bridge bank it had assembled, to Fleet/Norstar Financial Group Inc., backed by an investment from the leveraged buyout firm Kohlberg Kravis Roberts & Co. *Fleet/Norstar Completes Pact*, The Wall Street Journal (July 16, 1991).

a letter of intent to sell IndyMac Federal Bank, F.S.B., the successor in conservatorship to the failed IndyMac Bank, F.S.B., to IMB HoldCo LLC, a thrift holding company in which seven private equity funds are investors.²⁶ Only the lead investor, Dune Capital Management LP, is required to register as a thrift holding company. The acceptance of consortiums of non-banking investors as bidders on failing institutions is similar to the introduction of shelf charters as a means of inviting new sources of capital into the banking industry.

- *Loss Sharing.* A loss sharing arrangement, such as that included in the resolution of IndyMac Bank, Downey Savings and Loan Association, F.A., and several community banks, serves several purposes. It sets a limit on the purchaser's exposure to risk, other than interest rate risk (or substantially reduces the exposure to risk beyond a stated point), and transfers the remaining exposure to the FDIC.²⁷ At the same time, it enables the FDIC to keep covered assets off its books or to remove them from its books, in exchange for a contingent liability, and substantially reduces its costs of administration. The specific terms of or assets covered by each loss sharing arrangement are subject to some negotiation, but, in order for the FDIC to rely on a purchaser to manage assets for which the agency retains substantial exposure to loss, the FDIC must determine that the purchaser's risk of loss in a first tranche and its share of the risk in the remaining tranches is substantial enough to keep the parties' economic interests aligned. As part of the sale of IndyMac, the loss sharing arrangement, which is typical of recent transactions, provides for the investors to absorb all losses on the first 20% of the loans in the covered portfolio, the FDIC to absorb 80% of losses on the next 10% of the portfolio, and the FDIC to absorb 95% of any additional losses. The FDIC also agreed to continue to provide secured financing.²⁸ In a typical community bank resolution, the purchaser assumes all insured and uninsured deposits and acquires all or substantially all assets at a discount. A loss sharing arrangement covers a portfolio of single-family mortgage loans, and a separate arrangement covers certain other loans. For single-family loans, the purchaser agrees to absorb the first loss in an amount that may be subject to calculation based on the discharge of certain other liabilities of the failed bank, the

²⁶ *FDIC Board Approves Letter of Intent to Sell IndyMac Federal; Investor Group to Inject New Capital, Bring in Experienced Management Team*, FDIC PR-1-2009 (Jan. 2, 2009) (attached *Fact Sheet: FDIC Sale of IndyMac Bank*).

²⁷ *FDIC Turns to Old Tactic in IndyMac Deal*, American Banker (Jan. 8, 2009).

²⁸ *Ibid.*

FDIC agrees to absorb 80% of cumulative losses beyond this amount up to \$118 million, and the FDIC agrees to absorb 95% of cumulative losses beyond that amount. The FDIC's estimated cost for these receiverships, as a percentage of the assets of the closed institution, has been significantly lower than for traditional resolutions. The FDIC executed loss sharing agreements for the sale of five of the 16 community banks and thrifts that were closed in the first two months of 2009.²⁹

- *Creating new franchises.* The resolution of Downey Federal and PFF Bank & Trust, Pomona, California, on November 21, 2008, is notable because the failed institutions were unaffiliated, but were sold in a single transaction.³⁰ In other words, the FDIC marketed the two organizations as a single franchise, and found the whole to be more valuable than the sum of its parts. The FDIC achieved this result without incurring the costs of establishing a bridge bank or other corporate entity to house the combined organizations before their sale. This transaction suggests that the FDIC may look for similar opportunities or entertain similar proposals by interested bidders.³¹

- *Multiple winning bids.* On September 28, 2007, NetBank, Alpharetta, Georgia, was closed, and ING Bank, fsb, Wilmington, Delaware, assumed approximately \$1.5 billion of deposits and purchased approximately \$724 million of assets. The FDIC simultaneously announced the sale of approximately \$700 million of additional assets of the closed bank to EverBank, Jacksonville, Florida. NetBank had approximately \$2.5 billion of total assets, and the estimated cost of the receivership was \$110 million.³² On August 1, 2008, First Priority Bank, Bradenton, Florida, was closed, and the FDIC reached a similar agreement with two

²⁹ See, e.g., *Bank of Essex, Tappahannock, Virginia, Acquires All the Deposits of Suburban Federal Savings Bank, Crofton, Maryland*, FDIC PR-13-2009 (Jan. 30, 2009); Purchase and Assumption Agreement – Whole Bank – All Deposits, dated as of Jan. 30, 2009. Under loss sharing arrangements, the purchaser also agrees to implement a loan modification program based on that first employed by the FDIC in its conservatorship of IndyMac. This undertaking presumably gives the purchaser additional reason to seek protection from the FDIC as a result of any increased risk of loss that may be embedded in the program.

³⁰ *U.S. Bank Acquires All the Deposits of Two Southern California Institutions: Downey Savings & Loan Association, Newport Beach, and PFF Bank & Trust, Pomona*, FDIC PR-124-2008 (Nov. 21, 2008).

³¹ Such an initiative may introduce some moral hazard into the resolution process, if the FDIC had reason to encourage the closing of a troubled bank or thrift in order to add it, perhaps as the keystone, to a larger transaction serving the FDIC's ends.

³² *FDIC Approves the Assumption of the Insured Deposits of NetBank, Alpharetta, Georgia*, FDIC PR-81-2007 (Sep. 28, 2007).

purchasers.³³ The resolution of failed institutions by entering into agreements simultaneously with more than one bidder may be facilitated by the introduction of shelf charters as bidders, which creates an opportunity for more specialized bidders to participate. A specialized bidder may make a higher bid for limited categories of assets, but it is less likely than a traditional depository institution to be interested in multiple categories. To maximize the prices it receives and the amount of assets it sells at the time an institution is closed, the FDIC may find it in its interest to market failing institutions more aggressively to multiple bidders, particularly nontraditional bidders.

- *Structured finance arrangements.* One measure that the FDIC has begun to embrace to help it to divest assets it has retained is to enter into structured finance arrangements with third parties. As an alternative to placing loans into portfolios for inspection and sale through the FDIC's electronic loan auctions, such loans are handled in a manner similar to a loss sharing arrangement. On January 7, 2009, the FDIC completed its first structured sale of residential mortgage loans to Private National Mortgage Acceptance Company, LLC. The agency sold \$560 million of mostly delinquent mortgage loans that it acquired upon the closing of First National Bank of Nevada, Reno, Nevada, on July 25, 2008, for a sales price of \$43.2 million.³⁴ On February 26, 2009, the FDIC announced the sale of \$1.45 billion of performing and nonperforming residential and commercial construction loans in distressed markets through two public/private partnerships. These loans, which the FDIC also acquired as receiver for First National Bank of Nevada and for First Heritage Bank, N.A., Newport Beach, California, which were commonly owned, were placed in special purpose vehicles in which the agency has retained an 80% interest and the successful bidders, Diversified Business Strategies and Stearns Bank, N.A., St. Cloud, Minnesota, hold the remaining 20%. Upon the achievement of certain performance objectives, the FDIC's interest drops to 60%.³⁵ Such programs could be further structured to leverage the FDIC's participation, such as by the FDIC guaranteeing the debt

³³ *Sun Trust Bank Acquires the Insured Deposits of First Priority Bank, Bradenton, Florida*, FDIC PR-65-2008 (Aug. 1, 2008).

³⁴ *Ex-Leaders of Countrywide Profit from Bad Loans*, The New York Times (Mar. 4, 2009); *FDIC Looks to Get Rid of Toxic Debt with No Fuss*, Dow Jones Newswires (Feb. 6, 2009).

³⁵ *FDIC Closes on a \$1.45 Billion Structured Sale of Distressed Loans*, FDIC PR-26-2009 (Feb. 26, 2009). The FDIC reported that it received 30 separate bids from 18 bidders for both loan pools. The FDIC also stated that it has disposed of approximately \$3.2 billion of distressed loans through public/private partnerships in five separate transactions since the beginning of 2008.

issued by a special purpose vehicle, subject to appropriate safeguards, the payment to the FDIC of an appropriate fee, and the making of a systemic risk determination (such as was done for the FDIC's Temporary Liquidity Guarantee Program (TLGP) to authorize guaranteeing unsecured debt).³⁶

- *Powers of the receiver.* Finally, the FDIC may simply use its powers as receiver to facilitate a purchaser's integration of a closed institution. When JPMorgan Chase Bank, NA., acquired Washington Mutual Bank, it acquired 2,207 branches. On January 21, 2009, it announced its plans to close 299 branches based on overlapping coverage by the two institutions.³⁷ Under receivership procedures, Chase Bank had 90 days from the closing of Washington Mutual in which to notify the FDIC whether it desired to have any Washington Mutual office leases assigned to it, which provided Chase Bank the opportunity simply to leave with the FDIC any Washington Mutual branches that it intended to close.³⁸ The FDIC has avoided including a “put” provision for loans in its purchase and assumption agreements for failed institutions, since the exercise of this provision could burden the agency with large amounts of assets to administer. However, the FDIC is willing to include a comparable provision for lease obligations, which the agency is able to terminate with less liability than an acquiring institution would incur.³⁹ There may be additional situations in which the FDIC, through the exercise of its receivership powers, is able to terminate contractual obligations with less liability than an acquirer would incur, where it would be mutually advantageous for the FDIC to agree to exercise its powers as receiver in exchange for indemnification from the acquirer.⁴⁰

The FDIC also has taken broader policy initiatives that attempt to address, in the context of open bank operations, some of the same conditions that underlie the receivership actions discussed above. These initiatives do not provide opportunities for bidders in particular cases, but

³⁶ See 12 U.S.C. § 1823(c)(4)(G); *Temporary Liquidity Guarantee Program*, 73 Fed. Reg. 72244 (Nov. 26, 2008) (codified at 12 C.F.R. Part 370).

³⁷ *WaMu to Close 299 Branches, Many in Chicago*, Chicago Daily Herald (Jan. 21, 2009).

³⁸ See *Purchase and Assumption Agreement – Whole Bank* (Sep. 25, 2008).

³⁹ 12 U.S.C. § 1821(e)(4).

⁴⁰ In the Washington Mutual Bank receivership, the FDIC estimated that the resolution would have no cost to the DIF. *JPMorgan Chase Acquires Banking Operations of Washington Mutual*, FDIC PR-85-2008 (Sep. 28, 2008).

they may succeed, along with the efforts of the Department of the Treasury (Treasury) and the FRB, in improving the general financial condition of banks and thrifts and reducing the number of bank and thrift failures.

On October 14, 2008, the FDIC announced the introduction of the TLGP. This program has two components, an expansion of deposit insurance coverage and the provision of a guarantee of unsecured debt, backed by the full faith and credit of the U.S. government.⁴¹ Under the debt guarantee program, the FDIC, for an additional premium, has undertaken to guarantee unsecured debt issued by insured banks and thrifts, bank holding companies, savings and loan holding companies that only engage in activities that are permissible for a financial holding company under the Bank Holding Company Act, and additional affiliates with the approval of the agency. The amount of debt guaranteed is, in general, equal to not more than 125% of the unsecured debt of each covered entity that was outstanding on September 30, 2008. The guarantee applies to unsecured debt issued from October 14, 2008, through June 30, 2009, unless a depository organization has opted out, and remains in effect through the date the debt matures or June 30, 2012, whichever occurs sooner.⁴²

The debt guarantee program reveals the extent to which banks and thrifts rely on non-depository short-term borrowing to fund their operations. Depository institutions rely on, and need to maintain the trust and confidence of these investors, in much the same way as they rely on, and need to maintain the trust and confidence of their “core” depositors. This makes it prudent for the FDIC to take measures to protect certain non-depository creditors, just as deposit insurance protects depositors, in order to stabilize banks and thrifts. It will be interesting to see when, and to what extent, the FDIC will be able to withdraw this protection.⁴³

⁴¹ *FDIC Announces Plan to Free Up Bank Liquidity; Creates New Program to Guarantee Bank Debt and Fully Insure Non-Interest Bearing Deposit Transaction Accounts*, FDIC PR-100-2008 (Oct. 14, 2008).

⁴² 12 C.F.R. § 370.3. On February 10, 2009, the FDIC announced an extension of the program through October 31, 2009. *Interagency Statement on the Financial Stability Plan*, FDIC (Feb. 10, 2009). On February 27, 2009, the FDIC issued an interim rule that expanded the debt guarantee program to cover mandatory convertible debt, and it is reportedly considering including additional categories of obligations. *Modification of Temporary Liquidity Guarantee Program*, 74 Fed. Reg. 9522 (Mar. 4, 2009).

⁴³ An extension of the debt guarantee program to cover secured debt would be particularly noteworthy, in view of the FDIC’s traditional position that secured borrowing without sufficient oversight can worsen the condition of a troubled institution. For example, when announcing the sale of IndyMac, the Chief Operating Officer of the FDIC stated, “It is unfortunate that many of the banks that have failed last year [sic] had a heavy reliance on Federal Home Loan Bank advances. These secured borrowings and the

The FDIC also has taken a leading role in discussions regarding the formation of “bad banks” or “aggregator banks” to handle some of the distressed mortgage loans and mortgage-backed securities that weigh on many financial institutions, because it is perhaps the primary beneficiary of any such program.⁴⁴ As part of its Financial Stability Plan, the Treasury has announced a public/private initiative to acquire between \$500 billion and \$1 trillion of such assets.⁴⁵ Such a step should reduce the number of depository institutions that fail and the cost of resolving those that do fail, which would benefit the FDIC in general and the DIF in particular. In its basic form, the announced initiative is simply an acceleration of the implementation of structured vehicles for handling distressed assets from post-closing to pre-closing, in order to handle such assets before they cause the failure of entire organizations. Such a program also may enable the government to manage those assets more efficiently and effectively than in the helter-skelter of administering receiverships. There are significant policy considerations in shifting the cost of working out bad assets from depository institutions, which fund the DIF, and their stockholders, who risk losing their investment, to taxpayers. However, at a mechanical level, organizing public/private initiatives is consistent with the FDIC’s obligations as receiver, and argues for providing the FDIC a role in the design of the Treasury program.⁴⁶

The FDIC and the Treasury have worked together to encourage the development of covered bond programs as an alternative to mortgage loan securitizations.⁴⁷ Covered bond programs are viewed by many as being less subject to abuse than the originate-to-sell model underlying loan securitizations because the issuer of the covered bonds retains the loans on its

associated prepayment penalties have the effect of increasing the costs to the FDIC and to uninsured depositors.” *FDIC Board Approves Letter of Intent to Sell IndyMac Federal*, FDIC PR-1-2009 (Jan. 1, 2009); *see also* 74 Fed. Reg. 9525, 9540 (Mar. 4, 2009) (increase in assessment for institutions with secured liabilities in excess of 25% of deposits based on “inequity” of institutions paying reduced assessment on reduced deposit base). Indeed, if the FDIC were to guarantee a large portion of bank and thrift borrowing other than on a temporary basis, one may ask how the financial model would differ from the model of Fannie Mae and Freddie Mac before they failed, in which the perceived government guarantee of their obligations led to excessive leverage, privatized profit, and socialized risk.

⁴⁴ *FDIC’s Bair: Eyeing Aggregator Bank for Bad Assets*, Reuters (Jan. 16, 2009); *WSJ Interview: FDIC’s Bair Fleshes Out ‘Aggregator Bank’ Idea* (Jan. 16, 2009), available at <http://blogs.wsj.com/economics/2009/01/16/>.

⁴⁵ *Joint Statement*, Treasury TG-21 (Feb. 10, 2009).

⁴⁶ *Failed Banks Strain Regulators*, The New York Times (Feb. 14, 2009).

⁴⁷ *FDIC Board Approves Final Covered Bond Policy Statement*, FDIC PR-60-2008 (July 15, 2008); *Covered Bond Policy Statement*, 73 Fed. Reg. 43754 (July 28, 2008).

books. The bonds are general obligations of the issuer (or a special purpose vehicle that may be used as an intermediary), but they are secured by a pool of conforming, high-quality mortgage loans that are actively managed to maintain the bonds' coverage. However, such programs are not bankruptcy remote from the issuer, and, in the event of a receivership, the bondholders are at a disadvantage until the loans in the covered pool can be released to the indenture trustee. This process can be significantly delayed by the receiver's stay of proceedings against a failed institution.⁴⁸ The possibility of a lengthy delay has increased the cost of providing credit default coverage for covered bonds. To address this issue, the FDIC in a policy statement and the Treasury in a set of best practices have provided that, for investment grade covered bonds secured by conforming prime mortgage loans, the loans in the covered pool will be released no later than ten days after an institution is closed, thereby reducing hedging costs for those bonds. Covered bond programs would tend to increase the cost of receiverships to the FDIC, because fewer and poorer quality assets would remain available to cover insured depositors, and would deepen the losses of uninsured depositors and general creditors. Nevertheless, the FDIC has apparently determined that the risk of increased severity of loss would be more than offset by a decreased frequency of failures and improved underwriting and credit administration practices.

Recordkeeping requirements also have been enhanced in order to improve the administration of bank and thrift receiverships. The FDIC adopted a final rule in December 2008 that requires banks and thrifts that are in troubled condition to maintain enterprise-wide records of their positions in financial derivatives contracts, in order to assist the FDIC as receiver to make a rapid determination, as required by statute, to accept or reject an institution's qualified financial contracts.⁴⁹ The largest insured depository institutions also are required to identify and tag certain relationships among depositors and deposit accounts and the capacities in which those accounts are held, in order to expedite the determinations that the FDIC must make after an institution fails regarding the amount of depositors' insured deposits and their access to their accounts.⁵⁰

⁴⁸ 12 U.S.C. § 1821(d)(12).

⁴⁹ 73 Fed. Reg. 78162 (Dec. 22, 2008) (codified at 12 C.F.R. Part 371).

⁵⁰ 73 Fed. Reg. 41180 (July 17, 2008) (codified at 12 C.F.R. § 360.9).

Conclusion

The FDIC has avoided the largest recent threats to the DIF's solvency and its own operational capacity through the resolution of the largest failing institutions – Washington Mutual, Wachovia, and National City – at no direct cost to the FDIC. However, the increasing number of problem institutions suggests that additional cash and additional innovations may be required in order for the FDIC to stay ahead of its obligations. If necessity is the mother of invention, then crisis is the driver of regulatory creativity. This suggests that the most creative deals are yet to occur.