United States General Accounting Office

GAO

Report to Congressional Committees

May 1994

1992 BANK RESOLUTIONS

FDIC Chose Methods Determined Least Costly, but Needs to Improve Process

GAO/GGD-94-107

GAO United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-256292

May 10, 1994

The Honorable Donald W. Riegle, Jr.
Chairman
The Honorable Alfonse M. D'Amato
Ranking Minority Member
Committee on Banking, Housing, and
Urban Affairs
United States Senate

The Honorable Henry B. Gonzalez
Chairman
The Honorable Jim Leach
Ranking Minority Member
Committee on Banking, Finance and
Urban Affairs
House of Representatives

This report presents the results of our review of the Federal Deposit Insurance Corporation's (FDIC) compliance with Section 13(c)(4) of the Federal Deposit Insurance Act, as amended by The Federal Deposit Insurance Corporation Improvement Act of 1991. This section of the act requires FDIC to calculate and document its evaluation of the costs of all possible methods for resolving a troubled depository institution and to choose the resolution method that entails the least possible cost to the deposit insurance fund. These statutory provisions establish the basic requirements that FDIC must meet in making its least-cost determination.

The act requires that we annually audit FDIC's compliance with the least-cost provisions. This report is intended to provide information, analysis, and recommendations to improve the FDIC resolution process.

We are providing copies of this report to the Acting Chairman of the FDIC and other interested parties.

This report was prepared under the direction of Mark J. Gillen, Assistant Director, Financial Institutions and Markets Issues. Other major contributors are listed in appendix VII. If there are any questions about this report, please contact me on (202) 512-8678.

James L. Bothwell

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

From 1986 through 1993, resolutions of failed banks cost the deposit insurance fund about $31.93 billion. In an effort to stem insurance fund losses and to foster depositor discipline, Congress passed the least-cost resolution provisions contained in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).[1] These provisions were effective immediately upon FDICIA's enactment on December 19, 1991.

The least-cost resolution provisions of FDICIA generally require the Federal Deposit Insurance Corporation (FDIC) to resolve a failed bank in the least costly of all possible methods. The statute contains specific rules for calculating the costs of resolution alternatives and documenting the agency's evaluations of those costs. On the basis of this evaluation, the agency is required to select the least costly alternative. Finally, the statute requires GAO to annually report to Congress on FDIC's compliance with FDICIA's least-cost resolution provisions.

In accordance with this requirement, GAO assessed FDIC's compliance with the least-cost provisions, specifically with requirements for calculating costs and documenting the evaluation of the costs of resolution methods. In addition, GAO reviewed the marketing aspect of FDIC's resolution process.

Background

One of the first steps FDIC is to take toward resolving a failed bank is to estimate the cost of liquidation—basically, the amount of insured deposits paid out minus the net amount recovered through asset disposition activities (or net realizable value). FDIC is to compare the estimated cost of liquidation with the estimated costs of other resolution methods.

The least-cost provisions' cost-calculation requirements primarily apply to the adjustments FDIC makes to the book value of a failed bank's assets in estimating the net realizable value of those assets. The least-cost documentation provision requires FDIC to document its evaluation of the costs of the resolution alternatives considered, including the assumptions on which the evaluation is based.

Historically, FDIC has resolved failed banks using three basic methods. These include (1) directly paying depositors the insured amount of their deposits and disposing of the failed bank's assets (deposit payoff and asset liquidation); (2) selling only the bank's insured deposits and certain other

[1]Section 13(c)(4) of the Federal Deposit Insurance Act, as amended by FDICIA, P.L. 102-242, 105 Stat. 2236 (1992), effective December 19, 1991.

liabilities, with some of its assets, to an acquirer (insured deposit transfer); and (3) selling all of the failed bank's deposits, certain other liabilities, and some or all of its assets to an acquirer (purchase and assumption).[2] Within this third category, many variations exist based on specific assets that are offered for sale. For example, some purchase and assumption resolutions have also included loss-sharing agreements—an arrangement that allows the acquirer of the failed bank to share the losses on certain assets with FDIC.[3]

The resolution alternatives that FDIC considers in the agency's least-cost evaluations result largely from FDIC's efforts to market the failed bank. On a case-by-case basis, FDIC develops a marketing strategy for how to offer a failed bank to potential acquirers. The marketing strategy is shaped, according to FDIC policy, by the unique characteristics of the institution and marketing conditions at the time the strategy is developed. Typically, the marketing strategy includes any one approach or a combination of approaches to selling the failed bank's assets. In most cases, FDIC's marketing strategy includes a potential bid framework for both purchase and assumption and insured deposit transfer transactions. Each bid received is an individual resolution alternative that FDIC considers and evaluates in the agency's least-cost determination. According to FDIC policy, the agency considers bids that conform to the identified marketing strategy (conforming bids) as well as bids that do not conform to the marketing strategy (nonconforming bids).

To assess FDIC's compliance with FDICIA's least-cost rule, GAO reviewed a judgmental sample of 22 bank resolutions as well as FDIC's resolution procedures and interviewed FDIC officials.

Results in Brief

Generally, FDIC complied with the provisions on calculating the costs of resolution alternatives and documenting cost evaluations during 1992. FDIC's procedures to estimate the net realizable value of a failed bank's assets and to document cost evaluations improved in the latter half of 1992 as FDIC implemented and gained experience in using new procedures to estimate the net realizable value of the assets of failed banks. For a variety of reasons, some factors in the cost estimates were more uncertain than others. These factors included estimates of insured and uninsured

[2]In rare circumstances, unique resolution approaches are taken. For example, the recent resolution of CrossLand Savings Bank used a public stock offering to multiple investors. See Failed Bank: FDIC Sale of CrossLand Conservatorship Satisfied Least-Cost Test (GAO/GGD-94-109, Apr. 20, 1994).

[3]FDIC has also temporarily controlled and operated failed banks as "bridge banks" until acceptable acquirers are selected and approved.

deposits, future losses from loss-sharing agreements, and the future market value of bridge banks.

GAO's analyses of 22 sample resolutions indicated that FDIC consistently chose the resolution alternative FDIC determined to be the least costly compared to other alternatives considered. In 18 of the 22 cases, FDIC did not document its rationale for the marketing strategy it selected. FDIC's marketing decisions should be thoroughly documented and submitted to the FDIC Board of Directors for its consideration in making the least costly resolution decision. Although technically not required by FDICIA, such documentation would give the fullest effect of FDIC's statutory mandate to resolve failed banks in the least costly method.

Principal Findings

FDIC Generally Complied With Cost Calculation and Documentation Requirements

FDIC's methods to estimate the net realizable value of failed bank assets improved in the latter half of 1992. FDIC used three methods in 1992, all of them consistent with FDICIA calculation requirements. In the first half of 1992, FDIC generally used its pre-FDICIA method of reviewing on-site samples of assets and estimating the effect of current market conditions and risk factors on asset values by asset categories. By mid-1992, FDIC was using an improved on-site review of assets based on more narrowly defined categories, which enabled greater specificity and reliability in valuations. This improved technique led to clearer documentation of the bases for underlying assumptions. In certain circumstances where an on-site review of the failing bank's assets was not possible, FDIC used a third valuation method based on off-site statistical projections. FDIC officials stated that these projections were not as precise as the valuations based on on-site reviews.

Some resolution cost factors involved greater uncertainty than others. Most uncertain were estimates of uninsured deposits and losses to FDIC under loss-sharing and other asset disposition strategies. Typically, FDIC lacked precise information on uninsured deposit amounts because of the (1) complexity of deposit insurance coverage rules, (2) inadequacy of banks' reported financial information on deposit accounts, and (3) potential for deposits to be withdrawn at or near the time of bank closure. Estimates of losses under the relatively new loss-sharing agreements were uncertain because FDIC lacked historical data for accurate projections. FDIC realizes the need for such historical data and has initiated efforts to develop such information. Furthermore, estimates of losses under loss-sharing agreements were also uncertain because FDIC could not precisely predict future market conditions, including possible changes in asset values, interest rates, or economic conditions.

In all 22 bank resolutions that GAO reviewed, FDIC chose the resolution alternative that the agency determined was the least costly of all resolution alternatives it considered and evaluated. In all 22 cases, FDIC generally evaluated all bids received—including both conforming and nonconforming bids. The 22 cases included a total of 206 bids, 34 (about 17 percent of the 206 bids received) of which were nonconforming bids. Of the nonconforming bids, 20 (about 10 percent of the 206 bids received) varied in substantial ways from the conforming bids. In 4 of the 22 resolutions, FDIC determined that the nonconforming bid was the least costly resolution alternative.

Improved Documentation of Marketing Strategies Is Needed

GAO recognizes that, as a practical matter, FDIC must make judgments regarding how best to offer an institution for sale. In developing a marketing strategy, FDIC has considerable discretion to construct a strategy by selecting from among a large number of variations within the basic resolution methods in any given resolution. At the same time, the process by which FDIC selects its marketing strategy can affect the range of alternatives that are later considered in least-cost calculations once bids are received.

FDIC guidelines for developing marketing strategies were generally reasonable and designed to ensure that all resolution possibilities were to be considered in the development of such marketing strategies. However, the guidelines provide greater assurance of this for failed banks with assets under $1 billion than for those with assets greater than $1 billion. Under the guidelines, FDIC regional staff are to develop marketing strategies for banks having assets under $1 billion, and FDIC headquarters staff are to formally review these strategies. The guidelines also require FDIC headquarters staff to develop marketing strategies for banks having assets over $1 billion, but the guidelines do not provide for a formal review of the strategies developed.

GAO was unable to determine from available documentation how FDIC arrived at the marketing strategy for most of the 22 resolutions reviewed. In all 7 of the resolutions involving failed banks with assets over $1 billion and in 11 of the 15 resolutions involving smaller banks, GAO found that documentation of the rationale for the marketing strategy used to solicit bids was inadequate for a determination of FDIC's reasons for (1) selecting or rejecting various resolution methods, (2) offering or not offering loss-sharing agreements on certain assets, or (3) not offering poor quality assets for sale. Because these marketing decisions determined how failed banks were presented to potential acquirers, they may have affected the ranges of alternatives considered by both FDIC and potential acquirers.

To give the fullest effect to FDIC's statutory mandate to choose the least costly method, GAO believes that marketing decisions should be thoroughly documented and reviewed. In particular, the record in each resolution should address those methods that are potentially available and explain FDIC's rationale for selecting some and rejecting others. Further, the record should reflect a formal review of the marketing strategy developed to ensure all resolution possibilities have been considered. GAO believes that thoroughly documenting the record in each case would both enhance the quality of FDIC's decisionmaking and provide greater assurance to Congress and the public that resolution costs are being minimized.

Recommendations

GAO makes recommendations designed to improve the marketing aspect of FDIC's resolution process. It recommends that the Acting Chairman of the FDIC require the Division of Resolutions to (1) document the rationale for its marketing strategies for resolving all failing or failed banks and (2) submit the documented record of the marketing strategies to the FDIC Board for its consideration in making the least-cost resolution decisions.

Agency Comments

FDIC provided written comments on a draft of this report. These comments are presented and evaluated in chapter 3 and reprinted in appendix VI. FDIC concurred with GAO's findings and recommendations. FDIC said that it is updating its internal procedures to require documentation of the rationale for its marketing strategies and submission of the documented marketing strategies to the FDIC Board. GAO believes that these procedures, if effectively implemented, should provide FDIC better assurance that its statutory mandate to choose the least costly resolution method is being met.

Contents

Executive Summary		2
Chapter 1 Introduction		10
	Bank Resolutions Accelerated Beginning in the Mid-1980s	10
	FDIC's Evolving Resolution Methods	11
	Congress Passed FDICIA	13
	FDIC's Current Resolution Process	15
	Objective, Scope, and Methodology	20
Chapter 2 FDIC Complied With FDICIA's Cost Calculation and Documentation Requirements		22
	FDIC Complied With FDICIA's Requirements on Calculating Resolution Costs	22
	FDIC Improved Over Time the Documentation of Assumptions Underlying Asset Valuations	25
	FDIC Resolved Banks in the Least Costly Alternative of All Those Considered	26
	Uncertainties in Resolution Decisions	28
	FDIC Has Taken Steps to Improve Least-Cost Decisionmaking	31
	Conclusions	31
Chapter 3 FDIC Needs to Improve Its Documentation of Marketing Strategies		33
	FDIC Did Not Document Its Rationale for Marketing Strategies	33
	Conclusions	37
	Recommendations	38
	Agency Comments and Our Evaluation	38
Appendixes	Appendix I: Summary Data on GAO Sample of FDIC's 1992 Resolutions	40
	Appendix II: Bid Summary Data on GAO Sample of FDIC's 1992 Resolutions	43
	Appendix III: FDIC's Analysis of Resolution Alternatives	46
	Appendix IV: An Overview of FDIC's Asset Valuation Process and Methods	49
	Appendix V: FDIC's Treatment of Uninsured Depositors Under FDICIA: Losses Imposed More Frequently, in Larger Amounts	54
	Appendix VI: Comments From FDIC	64
	Appendix VII: Major Contributors to This Report	65

Tables

Table 1.1: FDIC Resolved and Assisted Banks, 1986-1993 — 10
Table 2.1: Resolution Alternatives Determined Least Costly by the FDIC Board in 22 Cases, in 1992 — 27
Table I.1: GAO Sample of FDIC's 1992 Resolutions — 40
Table I.2: Assets Retained by FDIC in GAO Sampled Resolutions — 41
Table II.1: Bid Summary Data on GAO Sampled Resolutions — 43
Table II.2: Analysis of Nonconforming Bids on GAO Sampled Resolutions — 45
Table V.1: Uninsured Deposits Held by Banks at Time of Failure, 1989-1991 — 55

Figures

Figure 1.1: FDIC's Typical Resolution Process — 17
Figure IV.1: FDIC's Typical Approach to Valuing Assets — 51

Abbreviations

AVR	Asset Valuation Review
BIF	Bank Insurance Fund
DOL	Division of Liquidation
DOR	Division of Resolutions
DOS	Division of Supervision
FDI	Federal Deposit Insurance
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
IDT	insured deposit transfer
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
P&A	purchase and assumption
RTC	Resolution Trust Corporation
TAPA	Total Asset Purchase and Assumption

Introduction

Resolving failed banks is a primary responsibility of the Federal Deposit Insurance Corporation (FDIC). Until 1991, FDIC could select any resolution alternative for a failed bank as long as that method was less costly to FDIC's insurance fund than liquidation, including the payment of insured accounts. However, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) generally requires FDIC to select the resolution alternative it estimates to be the least costly to its insurance fund.[1] The statute also requires FDIC to follow specific rules for calculating the costs of resolution alternatives and documenting the agency's evaluations of those costs, including the underlying assumptions of those evaluations. Finally, the statute requires us to report to Congress annually on FDIC's compliance with these requirements.

Bank Resolutions Accelerated Beginning in the Mid-1980s

From its formation on January 1, 1934, through 1942, FDIC handled an annual average of 47 failed banks. From 1943 through 1985, FDIC averaged only 11 failed banks a year. However, from 1986 through 1993, FDIC handled an average of 155 annual failures. During this 8-year period, failed bank assets totaled over $226 billion, and resolutions cost FDIC's insurance fund an estimated $31.93 billion. As shown in table 1.1, the number of failed bank resolutions had declined from its 1988 peak of 221 institutions to 42 institutions during 1993.

Table 1.1: FDIC Resolved and Assisted Banks, 1986-1993

Dollars in billions

Year	Number of banks	Total assets
1986	145	$7.63
1987	203	9.23
1988	221	52.62
1989	207	29.40
1990	169	15.74
1991	127	63.40
1992	122	44.23
1993	42	4.06
Total	**1,236**	**$226.31**

Source: FDIC Failed Bank Cost Analysis 1986-1992 and DOR 1993 statistics.

The significant increase in bank resolution activity since the mid-1980s led FDIC to reorganize its operating divisions—Division of Supervision (DOS)

[1]Section 13(c)(4) of the Federal Deposit Insurance Act, as amended by FDICIA, P.L. 102-242, 105 Stat. 2236 (1991), effective December 19, 1991.

and Division of Liquidation (DOL).[2] Before the reorganization, DOS was responsible for resolving failed banks with assets in excess of $100 million. The primary responsibility of DOS was to examine state-chartered institutions that were not members of the Federal Reserve System. DOL resolved small failed institutions (those having less than $100 million in assets). The primary responsibility of DOL was to sell failed institution assets remaining and assumed by FDIC after resolution.

In March 1991, FDIC established the Division of Resolutions (DOR) to plan for and handle bank resolutions. By centralizing much of the work related to bank failures that had been split between DOS and DOL, FDIC expected its new division, DOR, to yield increased efficiency, reduced costs, consistent decisionmaking, and more in-depth resolution expertise. DOR was staffed primarily by transferees from the Resolution Trust Corporation (RTC), DOS, and DOL; thereby enabling DOR to assume its responsibilities with a historical perspective of how FDIC resolved failing institutions. In addition, some senior management positions were filled through external hires from the financial services industry and from other federal agencies.

FDIC's Evolving Resolution Methods

Initially, FDIC had two methods for handling bank failures: deposit payoffs or deposit assumptions. When deposits were paid off, FDIC made payments directly to the depositors up to the insurance limit and subsequently sold the failed bank's assets. The cost of the payoff essentially was the difference between the amount disbursed to insured depositors minus the net funds received from asset sales. In deposit assumption transactions, an acquiring bank assumed the insured, and generally the uninsured, deposits of the failed bank.

By the late-1960s, FDIC began to actively pursue purchase and assumption (P&A) transactions. In P&A transactions, the acquiring bank agreed not only to assume deposits and pay a premium, but also to purchase at least some of the failed bank's assets. FDIC handled most bank failures this way until the late-1980s.

By 1987, FDIC's preferred resolution method evolved to a whole bank P&A transaction in which most if not all of a failed bank's assets and deposits, as well as other bank liabilities, were acquired by another institution. This method generally protected uninsured depositors and minimized the assets requiring sale by FDIC. Other methods that were available to FDIC,

[2] In October 1993, DOL was reorganized and renamed the Division of Depositor and Asset Services. DOS currently operates under its original name.

and are still being used to resolve failing or failed banks, included other types of P&A transactions, an insured deposit transfer (IDT), open bank assistance, and bridge bank arrangements. In each of these methods, except for IDT, the acquirer has the option of assuming all deposits or only the insured deposits. Following is a brief description of these other types of resolution methods.

- Other P&A transactions.
- Clean bank P&A. The acquirer purchases only high-quality assets, which are basically those loans that are performing and have a high likelihood of being repaid.
- P&A transactions with asset pools. The acquirer's purchases could include many variations of asset groupings that are referred to as asset pools.
- P&A transactions with putback or loss-sharing agreements. These agreements are used for asset groupings that both FDIC and acquirers believe may be difficult to get borrowers to repay, such as those loans in which the collateral value has fallen below the loan amount remaining due. Putback agreements enable the acquirer to return certain assets to FDIC within a specified time period, while loss-sharing agreements enable the acquirer to recover from FDIC a stipulated percentage of losses incurred on certain purchased assets. During 1992, several resolutions included loss-sharing agreements on certain assets, in which FDIC will reimburse acquirers 80 percent of net charge-offs, up to a pre-set limit, of those assets over a specified period of time.[3]
- Insured deposit transfer. The acquirer accepts the failed bank's insured deposits and makes them available to depositors. The acquirer may also assume certain other liabilities and purchase some of the assets.
- Open bank assistance. FDIC can provide financial assistance to a troubled bank before it is declared insolvent or closed. In such instances, FDIC uses its marketing techniques to actively seek an acquirer for the bank or otherwise ensures itself that the bank's current management can provide for the bank's viability.
- Bridge bank. FDIC can establish a bridge bank to take interim control of the operations of a troubled bank. It can operate the bank temporarily (up to 2 years with the option for three 1-year extensions) to preserve the franchise value—that is, its value as an ongoing entity—until a final resolution decision is made.

FDIC's preference for whole bank transactions did not preclude potential acquirers from making other types of bids. However, FDIC's bid evaluation

[3]For the loss-sharing agreements used in 1992 resolutions, FDIC typically increased the loss-sharing level to 95 percent for losses above the pre-set limit.

process prior to FDICIA clearly focused on its preference for whole bank bids. The bid evaluation process was to separate whole bank bids from all other types of bids received.[4] Staff were to then evaluate the whole bank bids, select the best one, and determine whether it would be less costly to FDIC than a liquidation. If so, staff were to recommend its acceptance and stop the bid evaluation process. All other bids were to be returned unopened to the potential acquirers. If staff found there were no acceptable whole bank bids, they were to evaluate other types of bids based on a pre-established order, which gave preference to the greater amount of assets to be purchased by the potential acquirer. Since FDIC did not evaluate all bids received, it did not have the data to know the effect its preference for the whole bank resolution method had on resolution costs and thus on its deposit insurance fund.

As the number of institutions needing resolution increased in the late-1980s, so did their cost, and thus the losses, to FDIC's deposit insurance fund.[5] Basically, the deposit insurance fund receives revenue from deposit insurance premiums from FDIC-insured institutions, interest earned on investments in U.S. Department of the Treasury obligations, and sales of FDIC-owned failed bank assets. The fund's proceeds are used to meet FDIC's obligation to provide insurance coverage for insured deposits in a failed institution and to provide financial assistance in resolving that institution. In 1987, the fund's reserves reached $18.3 billion, the highest level ever. However, the upsurge in bank failures caused the fund to lose more than $25 billion over the next 4 years, and by December 1991, it was $7 billion in the red.

Congress became increasingly concerned that the declining health of the banking industry and mounting BIF losses would necessitate a taxpayer-assisted bailout similar to that for the savings and loan industry. Congress also questioned whether BIF should continue to pay uninsured depositors. Paying uninsured depositors was typically part of FDIC's preferred resolution strategy for whole bank transactions.

Congress Passed FDICIA

To address its concerns about the financial health of the deposit insurance funds, Congress in December 1991 passed the least-cost resolution provisions contained in FDICIA. Essentially, the purpose of FDICIA, as it

[4]FDIC refers to this process, which established the agency's priority for evaluating bids, as the "Robinson Resolution."

[5]The deposit insurance fund was named the Bank Insurance Fund (BIF) with the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. BIF was established to provide deposit insurance to all federally insured banks.

relates to resolutions, is to (1) provide backup funding for federal deposit insurance and (2) reduce losses when depository institutions fail.[6] Because of the deteriorating condition of BIF, Congress increased FDIC's line of credit with the Treasury to $30 billion and required FDIC to prescribe a recapitalization schedule for BIF.

Congress sought to limit BIF losses, in part, by improving the regulatory process. In addition, FDICIA contains key provisions pertaining to the resolution of failing or failed banks. Most significantly, Section 141 requires FDIC to choose the resolution method least costly to BIF of all possible methods for meeting FDIC's obligation to provide insurance coverage for insured deposits in failed institutions.[7] To make this least-cost determination,[8] FDIC must

- consider and evaluate all possible resolution alternatives by computing and comparing their costs on a present-value basis, using realistic discount rates;
- select the least costly alternative based on the evaluation;
- document the evaluation and the assumptions on which it is based, including any assumptions with regard to interest rates, asset recovery rates, asset holding costs, and contingent liabilities; and
- retain documentation for at least 5 years.

FDICIA further required that we annually audit FDIC's compliance with the least-cost provisions.

In passing FDICIA, Congress expected to reduce the cost of bank failures to BIF. For instance, Congress intended for uninsured depositors to share in resolution costs. Thus, FDIC now can provide coverage to uninsured depositors only in conjunction with a least-cost resolution.

[6]FDICIA applies to both FDIC and RTC relative to their responsibilities for resolving failing or failed banks or thrifts, respectively. We reported separately on the RTC's compliance with FDICIA's least-cost provisions. See 1992 Thrift Resolutions: RTC Policies And Practices Did Not Fully Comply With Least-Cost Provisions (GAO/GGD-94-110, 1994).

[7]Section 13(c)(4)(G) of the Federal Deposit Insurance Act provides for a systemic risk exception to the least-cost requirement if a finding is made that compliance with the least-cost requirement would have serious adverse effects on economic conditions and that a more costly alternative would mitigate such adverse effects. To date, FDIC has not relied on this exception.

[8]Section 13(c)(4) imposes specific requirements concerning the treatment of certain costs. For example, Section 13(c)(4)(B)(ii) provides that if FDIC considers an alternative that would result in forgone federal tax revenues, it must treat those revenues as if they were revenues forgone by the deposit insurance fund. Section 13(c)(4)(D) deals with the calculation of liquidation costs for purposes of cost comparisons.

In an earlier report on FDIC's resolution of CrossLand Savings Bank,[9] we were critical of the quality and extent of its documentation. In that report, we established the following criteria, which FDIC accepted.

- Documentation should be clear, consistent, concise, and complete so that an outside observer can identify and understand the estimated cost of each alternative, including the assumptions and discount rates used.
- Data sources for the cost evaluations should be clearly identified so that cost figures can be traced to their source(s).
- Assumptions integral to the cost evaluations should be documented and supported. In particular, each assumption should be (1) clearly identified and (2) supported by empirical data or, in the absence of such data, by judgment based on relevant experience. This support should be explicitly described in the documentation and, where appropriate, the source(s) used in making the assumption should be identified.
- If there is uncertainty about the validity of an assumption that materially affects the cost evaluation results, some effort to gauge that uncertainty should be made and documented by showing a range of possible outcomes.

We also used these criteria in assessing the sampled resolutions for this review to determine the adequacy of FDIC's documentation of its cost evaluations and underlying assumptions.

FDIC's Current Resolution Process

DOR is responsible for resolving failed banks within FDIC. A bank fails when its chartering authority, the Office of the Comptroller of the Currency (OCC) for national banks or a state authority for state chartered banks, closes the institution. At that time, FDIC is usually appointed receiver.[10] The FDIC Board may also appoint FDIC as receiver for any insured depository institution, after consultation with the appropriate federal and state regulators, when such action is necessary to reduce the risk of loss to the deposit insurance fund.

The marketing and resolution of failed banks is done through either a regional or headquarters resolution process. The processes are quite similar. Generally, DOR's regional offices handle institutions with less than

[9]Failed Bank: FDIC Documentation of CrossLand Savings, FSB, Decision Was Inadequate (GAO/GGD-92-92, July 7, 1992).

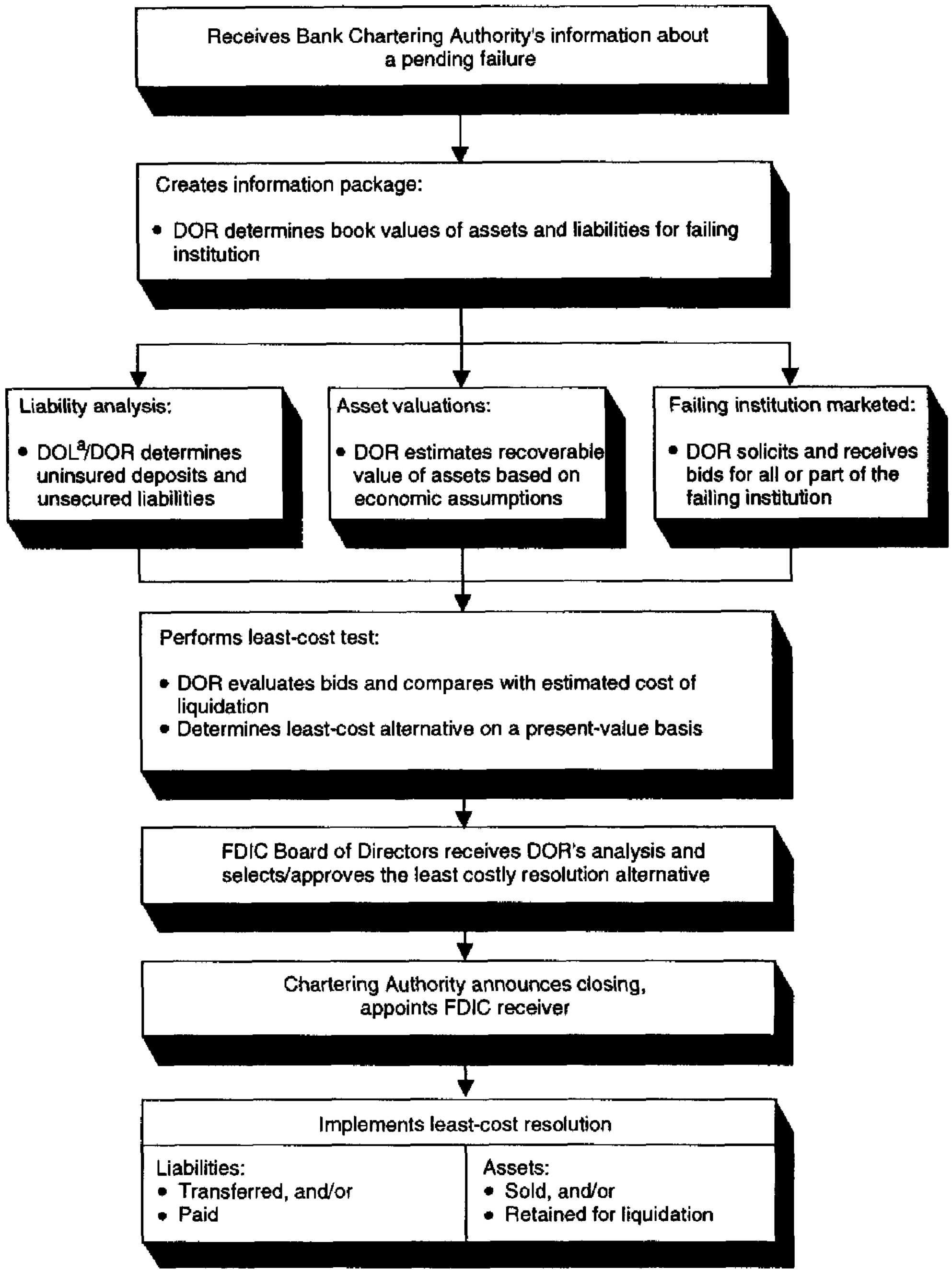
[10]A receivership is the functional equivalent of bankruptcy for a failed bank. FDIC, as receiver, is responsible for the disposition of the assets of a failed bank and repayment of its creditors to the best extent possible. For national banks, OCC is required to appoint FDIC as receiver.

$1 billion in total assets, known as regional resolutions, while larger institutions or major resolutions are done at DOR headquarters in Washington, D.C.

FDIC's formal resolution activities commence when it receives a letter from the chartering authority advising FDIC of the imminent failure. DOS then is to provide DOR a failing bank case memorandum, which summarizes the bank's problems, its ownership, and the results of previous examinations. DOS also is to give DOR a list of institutions approved to bid on the bank because they meet certain criteria such as asset size and minimum capital requirements.[11] Figure 1.1 shows FDIC's typical resolution process.

[11]DOS generally consults with other federal regulators on the bidders list and with the primary regulator for input for the case memorandum on national or state member banks.

Figure 1.1: FDIC's Typical Resolution Process



[a]In October 1993, DOL was reorganized and renamed the Division of Depositor and Asset Services.

Source: GAO review of DOR procedures.

DOR then is to prepare an information package on the institution, which provides an in-depth description and accounting of the bank's financial condition. The purpose of the information package is to inform potential buyers of the composition of assets to be acquired and liabilities to be assumed. DOR staff also are to use the information package to begin developing a marketing strategy.

In selecting a marketing strategy, DOR is to consider the alternative resolution methods identified in its Resolutions Procedures Manual. Numerous approaches may be considered—including some very complex combinations of resolution approaches. For those resolutions done in the field, regional officials are to prepare and submit to a DOR headquarters official a failing bank recommendation, which is to outline those resolution methods considered viable. The headquarters official is to review this recommendation and approve the resolution methods to be offered to potential acquirers in DOR's marketing strategy. For those resolutions done at headquarters, DOR headquarters officials are to determine the marketing strategy. FDIC sells no assets of a failed bank until the bank has been closed and turned over to FDIC for resolution. FDIC's marketing activities and its analysis of resolution alternatives are discussed further in appendix III.

Concurrent with developing a marketing strategy, DOR staff are to contract for or prepare a valuation of the failed bank's assets. The valuation is an estimate of the amount that FDIC would recover if it were to sell the assets—the net realizable value. The net realizable value usually differs from the book value of the assets, as recorded in the information package, because of reasons such as costs associated with the length of time FDIC holds the assets prior to sale; changes in interest rates since the loan was initially made; and changes in the value of the underlying collateral, which may affect the amount recovered by FDIC on the assets. Detailed computer models are to be used in valuing assets that employ numerous variables and estimates, making this a very complex process. In the event of a deposit payoff and asset liquidation, FDIC's total resolution cost is basically the sum of payments to insured depositors and secured creditors minus the net realizable value on the bank's assets.

Creditor analyses are also to be done at this time. Upon receiving DOL's estimate of the amount of uninsured deposits, DOR is to estimate the amount of insured deposits in the bank. FDIC's legal staff estimates the amount of contingent liabilities. These liabilities may include standby letters of credit, unfunded loan commitments, or liabilities from pending litigation.

After agreeing on a marketing strategy, DOR officials are to hold an information meeting with potential acquirers. The acquirers are invited from the previously mentioned DOS bidders list. The proposed transaction is to be discussed and those with continuing interest in the institution are to sign a confidentiality agreement, receive the information package, and secure permission to perform due diligence. Due diligence is the bidder's on-site inspection of the books and records of the institution and an assessment of the value of the assets and liabilities done for the purpose of preparing a bid.

During the information meeting, DOR is to advise potential acquirers when bids should be submitted. Bids received are evaluated and compared with each other and FDIC's estimated cost of liquidation in order for DOR to arrive at the least costly resolution alternative. Once the least cost test is complete, a decision package is to be prepared for FDIC's Board of Directors requesting approval of the transaction. The decision package is also to include information about the share of the estimated loss that should be absorbed by uninsured depositors, and whether an advanced dividend should be paid to uninsured depositors so that they have a portion of their deposited funds, while FDIC proceeds with the resolution and disposition of the remaining assets.

The FDIC Board is responsible for making the final resolution decision. Resolution decisions involving institutions with assets of $300 million or more are to be scheduled for discussion by the Board. The Board may accept the cost analysis provided by DOR, seek additional information, or request DOR to provide a new cost analysis based on factors identified during the Board meeting. Resolutions involving institutions with less than $300 million in assets are placed on the Board's summary agenda. FDIC officials indicated that resolutions on the summary agenda may be approved by the Board without discussion. At times, for these smaller resolutions, the Board may delegate authority to DOR to select the final resolution alternative. In such cases, DOR must report its decision to the Board.

This entire resolution process is generally carried out between the time the chartering authority advises FDIC that a bank is in imminent danger of failing and the time the charterer appoints FDIC as receiver. This time period can be as short as a few weeks or as long as several months. FDIC is required to make a least-cost determination at the time it makes a determination to provide financial assistance to the institution. Thus, the time available and access to bank information are critical to the precision of the numerous estimates that must be made in determining the least costly resolution. However, some imprecision will always remain in least-cost determinations because of factors such as complex deposit insurance rules and changes resulting from future market and economic events.

Objective, Scope, and Methodology

The overall objective of our review was to determine the extent to which FDIC complied with FDICIA requirements to select the least costly method of resolving institutions. In this first report on FDIC's compliance, we surveyed the FDIC resolution process, which continues to evolve, to identify the key controls and potential vulnerabilities. From our survey, we concentrated our detailed analysis on FDIC's process for (1) calculating the cost of resolution alternatives and (2) documenting its evaluation of those alternatives considered in selecting the least costly resolution alternative.

To address our objective, we judgmentally selected for review 42 of the 122 banks resolved by FDIC during 1992. The 42 banks—all of which were resolved after passage of FDICIA—had assets of $29.8 billion and had an estimated resolution cost to BIF of $2.2 billion, while the 122 banks had assets of $44 billion and had estimated BIF losses of $4.7 billion. The 42 banks represented 22 resolutions, since 20 banks were included in a resolution of First City Bancorporation of Texas and 2 banks were included in a resolution of American Savings Bank. Our selection criteria included headquarters and regional resolutions and varying attributes such as different types of resolution methods. Of the 22 resolutions, 7 major resolutions were done at DOR headquarters in Washington, D.C., and 15 regional resolutions were done at DOR regional offices—5 each in Boston, New York, and San Francisco. See appendix I for profile information relative to the 22 sampled resolutions.

We developed a data collection instrument to document and track the information gleaned from our perusal of the resolution case files. We collected data from the inception of resolution activity through the final resolution decision. In particular, we focused on DOR's approaches to marketing the institution, performance of asset valuations, documentation of the assumptions used, bids received and costed via application of the cost test, and the treatment of uninsured depositors.

Since asset valuations are a crucial input to the least-cost determination, we reviewed in considerable detail the computer programs underlying the models developed by FDIC to value assets. We concentrated primarily on the assumptions and financial calculations used in the models to determine whether they would result in reasonable valuations. We also discussed FDIC's program logic and methodology with officials from large private organizations actively involved in performing due diligence and purchasing bank-type or similar assets. Obtaining information on their asset valuation approaches provided us a basis for assessing the adequacy of FDIC's efforts. We did not review the supporting documentation of FDIC's valuations of thousands of individual bank assets to ensure their accuracy. Instead, we focused on the valuation process and how its results were used in FDIC's cost tests for our sampled resolutions with the limited time and resources available for this first annual review.

To further address our audit objective, we studied FDIC's resolution process including reviewing its procedures and practices and interviewing numerous FDIC officials, including those in the FDIC Inspector General's Office responsible for reviewing resolutions programs and activities. We also reviewed the financial calculations developed by DOR to determine whether the estimated cost of resolution alternatives was accurately calculated.

We assessed the adequacy of FDIC's resolution process to determine the least costly resolution alternative based on the criteria developed in our earlier report on CrossLand Savings Bank.[12] We did not determine whether, in fact, the least costly resolution alternative resulted. The ultimate cost of a resolution cannot be identified until all remaining assets are sold and liabilities are paid by FDIC as receiver, which generally takes several years.

We did our work between October 1992 and December 1993 at FDIC headquarters in Washington, D.C., and DOR regional offices in Boston, New York, and San Francisco. FDIC provided written comments on a draft of this report. These comments are presented and evaluated in chapter 3 and are reprinted in appendix VI. Our work was done in accordance with generally accepted government auditing standards.

[12]GAO/GGD-92-92, July 7, 1992.

FDIC Complied With FDICIA's Cost Calculation and Documentation Requirements

FDIC improved its processes for calculating and documenting resolution cost estimates throughout 1992. By mid-year, FDIC had gained experience with the new FDICIA requirements and had developed processes to satisfy those requirements. Also, FDIC's related documentation procedures had been sufficiently improved to ensure compliance with FDICIA's requirements for calculating estimated resolution costs and documenting cost evaluations and their underlying assumptions. The least-cost provisions contained in FDICIA were effective on December 19, 1991, immediately upon the act's enactment.

Resolution decisions involve many uncertainties, including unanticipated gains and losses in the value of assets held in receivership and the outcome of lawsuits pending at the time of a resolution decision. As discussed later in this chapter, other uncertainties relate to estimates of uninsured deposit payouts and future proceeds under loss-sharing and other asset disposition agreements. FDIC recognized the need and opportunity to reduce such uncertainties and initiated positive efforts in 1992. However, the complexity of insurance coverage rules and unreliable bank-reported information limit improvements that can be made in estimating total uninsured deposits in failed banks. Also, decisions to operate a failed bank as a bridge bank also involve uncertainties and raise policy issues about uninsured depositors.

FDIC Complied With FDICIA's Requirements on Calculating Resolution Costs

As outlined in chapter 1, one of FDIC's first activities to resolve a failed bank is that DOR prepares an information package on the institution's assets, deposits, and other liabilities. Information in the package is based on the institution's financial records as of the date the package is prepared. This package provides potential acquirers and DOR with a common base of information to estimate (1) the amount that potential acquirers may bid for the institution's assets and deposits and (2) the net realizable value of the institution's assets.

Basically, DOR is to estimate liquidation costs by calculating the difference between the result of DOR's asset valuation and the amount to be paid to insured depositors. Therefore, asset valuations are critical to determining the cost of liquidation; the cost of liquidation is, in turn, critical to FDIC's determination of the least costly resolution alternative. To make this determination, DOR first is to compare the estimated liquidation cost with the bids from potential acquirers to see if an acquisition is less costly than a liquidation. If so, then FDIC compares the bids received to determine which would be the least costly to the Bank Insurance Fund (BIF).

While some types of assets can be valued with a fair degree of precision, others must be valued judgmentally on the basis of a number of often uncertain factors. The amount of cash can be precisely determined as can the value of marketable securities from readily available financial sources. However, the values of loans, which typically make up the bulk of bank assets, are more difficult to determine. Loans such as mortgages and consumer loans must be valued with consideration to the risk associated with repayment, the value of any underlying collateral, and other factors. Even more imprecise are the valuations of loans that involve borrower defaults and bank foreclosures.

FDICIA requires FDIC to calculate the cost of each resolution alternative on a present-value[1] basis and to use a "realistic discount rate." This provision primarily affects the method that FDIC uses to adjust the book value (or the value reflected in bank records) of a failed bank's assets when valuing the assets. A failing bank's records generally reflect asset values based on historical cost. FDIC has found that these values generally overstate the value that can be recovered through the agency's liquidation of the assets. FDICIA leaves to FDIC's discretion the definition of realistic discount rates, as well as the specific factors the agency considers in valuing assets such as the holding costs that may be incurred by FDIC pending the sale of assets, which can affect the amount FDIC may realize once assets are sold.

FDIC Used Three Models to Estimate the Value of Failing Bank Assets

During 1992, FDIC used three models to estimate the present value of assets held by failing banks. Two of the models, the Total Asset Purchase and Assumption (TAPA) asset review and the Asset Valuation Review (AVR), evaluated all types of assets held by a failing bank on the basis of on-site reviews of sampled loan asset files and other asset records at the bank. AVR, which replaced TAPA, was an improvement over the TAPA asset review in that AVR sampled across more narrowly defined categories of asset pools and provided more extensive analysis of the asset pools within the portfolio than the TAPA asset review. When an on-site review of a failing bank's assets was not possible because of the bank's liquidity problems such as limited ability to meet depositors' fund withdrawals or legal problems, FDIC used a third model, a statistical research model based on data from FDIC's recovery experience. FDIC also used the research model as a means of checking the reasonableness of TAPA and AVR results, but relied on the TAPA and AVR results after any changes were made resulting from

[1]Present-value analysis is used to calculate the current value of a future payment or stream of payments. That is, it recognizes and adjusts for the fact that $100 received 5 years from now is worth less than $100 today because of the time value of money, risks, and inflation.

the comparison to the research model results. Appendix IV provides further description of FDIC's three asset valuation models.

For all 22 resolutions we reviewed, FDIC used these models in its valuations of assets to estimate the net present value that the agency could recover through liquidation and to estimate resolution costs. Of the 22 resolutions we reviewed, 5 used the TAPA asset review; 12 used AVR; and 5 used the research model. All resolutions that used TAPA asset reviews were done in early 1992, while the research model was used occasionally throughout the year, as circumstances dictated.

FDIC's Asset Valuation Methods Designed to Use Realistic Discount Rates in Estimating Present Values of Assets

We determined that the asset valuation methods FDIC used in our 22 sampled resolutions complied with the FDICIA calculation rules. We also determined that the bases of FDIC's TAPA and AVR valuation methods—its calculation of present value and the discount rates used in the calculations—were consistent with those generally used by private sector firms experienced in valuing and acquiring bank assets as well as by academicians who have studied such valuations.

FDIC's selection of discount rates varied according to a variety of factors, for example, market rates at the time of the resolution and risks associated with the assets, such as credit risks. FDIC's research model also uses a present-value calculation method using a discount rate reflecting FDIC's cost of funds.

To determine if FDIC's valuations of assets were calculated based on present value with realistic discount rates, we reviewed FDIC's asset valuation methods and FDIC's documentation for determining realistic discount rates in estimating the present value of a failed bank's assets. Also, to better understand the selection of discount rates and the use of present-value analysis, we reviewed the academic literature on asset valuation and interviewed officials of five private sector firms, including banks and securities and investment firms involved with valuing asset portfolios similar in type to those of many banks.

Private sector officials said that present-value analysis requires assets to be judged in terms of a variety of aspects and market conditions. The analysis often requires estimating the timing and amount of cash flows from an asset to an investor. The cash flows generally represent an investor's return (yield) on the asset. If the investor's yield differs from current market rates for similar assets, the asset value—or selling price—is adjusted or discounted by an amount to essentially provide an investor a yield comparable to the current market rate.

The officials said that they used discount rates based on a variety of factors. Some of the factors they mentioned included (1) the firms' investment objectives, (2) the relative quality of the asset to be acquired, (3) the length of time the asset would be held, and (4) how the quality of the asset might change during the period held.

FDIC Improved Over Time the Documentation of Assumptions Underlying Asset Valuations

FDICIA requires FDIC to document the agency's evaluation of the costs of resolution alternatives considered, including the assumptions on which the evaluations are based. FDICIA specifically requires documentation of any assumptions that relate to interest rates, asset recovery rates, asset holding costs, and payments of contingent liabilities. It also requires such documentation to be retained for at least 5 years. In reviewing the 22 sampled resolutions, we attempted to identify the underlying assumptions of asset valuations, including the assumptions specified in the least-cost provisions. We focused primarily on DOR's process for documenting its AVR valuations because in 1992 FDIC developed and implemented this methodology in response to FDICIA's requirements.

We generally found that FDIC's capability to document these assumptions improved after the agency implemented its AVR methodology. We had greater difficulty and limited success in identifying the underlying assumptions made in the research model and TAPA, which were designed before FDICIA was enacted. Asset valuations, using the research model and TAPA, were based on DOL's asset disposition experience with assets held by failing banks. Although holding costs, holding periods, and recoveries on assets are inherent in that experience, the resolution case files we reviewed generally lacked documentation that explained specifically how these factors figured in asset value calculations.

We found that as DOR gained more experience with AVR, the division improved required procedures for preparing AVR reports as well as the procedures for organizing and maintaining resolution case records. For example, AVR procedures required documentation of methods used to value assets. The AVR reports we reviewed complied with these procedures by documenting the factors and assumptions underlying the calculations used to determine the values and losses in the value of assets held by a failing bank. We also found that the AVR reports we reviewed generally met our criteria, as discussed in chapter 1, for documenting the valuations FDIC expects to use in evaluating the costs of resolution alternatives.

DOR made further improvements to the AVR documentation. Specifically, it required clear identification, in a separate report section, of key assumptions about holding periods, holding costs, and selling expenses. This section of the report, along with its discussion of asset valuation methodologies, allowed us to identify the underlying assumptions of the asset valuation process.

We found that the underlying assumptions used in AVRs we reviewed were often based on DOL's asset disposition experience, and in some cases, on surveys of local firms dealing with the same types of assets being valued.[2] In valuing the assets for one major bank, for example, the valuation team contacted local liquidation firms to determine the current market values for office equipment assets such as desks and furnishings. The valuation team also contacted local art dealers to determine the potential value of an art collection held by the failing bank.

To provide an assessment of the effect of a failed bank's letters of credit, lawsuits filed against and on behalf of a failing bank, and other contingent liabilities, AVRs we reviewed usually incorporated estimates from a separate valuation report prepared by a team composed of FDIC liquidation and legal personnel. Like recoveries on assets, the outcome of lawsuits and other contingent liabilities may not be known for several years after the resolution of a failed bank.

FDIC Resolved Banks in the Least Costly Alternative of All Those Considered

In all 22 cases we reviewed, the FDIC Board chose the resolution alternative that FDIC's DOR had determined to be the least costly of the alternatives considered. We found one instance where the Board revised the cost estimates presented by DOR; however, this revision, which lowered the estimate of FDIC's loss in this resolution, did not change DOR's recommendation of the least costly resolution alternative. The case was a complex resolution involving a holding company that controlled 20 banks. The recommended least-cost resolution alternative was a bridge bank for each of the 20 banks. The Board estimated that FDIC's recovery on assets would be greater than DOR estimated, mainly because of the market interest in the banking franchise. In this resolution case, we were unable

[2]See Financial Audit: Federal Deposit Insurance Corporation's Internal Controls as of December 31, 1992 (GAO/AIMD-94-35, Feb. 4, 1994). We have found internal control weaknesses relative to FDIC's asset management and disposition information. FDIC officials have acknowledged and agreed to initiate actions to overcome those reported weaknesses.

to trace FDIC's analysis of resolution alternatives to documents providing empirical evidence to support the Board's revised estimate of recovery on assets. However, we encountered no similar difficulties in any other of the 21 resolutions we reviewed. The closure and resolution processes for this banking franchise are the subject of a separate GAO study, which will be issued later this year.

Table 2.1 shows the resolution alternatives that the FDIC Board selected as the least costly alternative for the 22 bank failures we reviewed.

Table 2.1: Resolution Alternatives Determined Least Costly by the FDIC Board in 22 Cases, in 1992

Least costly resolution alternative	Banks with assets under $1 billion	Banks with assets over $1 billion	All banks
Whole bank P&A	0	2	2
P&A	8	3	11
IDT[a]	3	1	4
Bridge bank	0	1	1
Liquidation	4	0	4
Total	**15**	**7**	**22**

[a]IDTs included the purchase of assets in three cases. The acquirer typically purchased the failed bank's most marketable assets, such as cash, securities, and some performing loans.

Source: GAO analysis of sampled resolution cases.

DOR Generally Evaluated All Bids Received

In the 22 cases we reviewed, we found that FDIC generally evaluated all bids received for a failing bank. FDIC received a total of 206 bids[3] from 89 potential acquirers in the 22 cases we reviewed. Of the 206 bids, 34 were nonconforming bids.

Bids submitted to FDIC fall in two categories—conforming bids, which match FDIC's marketing strategy and nonconforming bids, which differ from FDIC's marketing strategy. A nonconforming bid may or may not be significantly different from FDIC's recommended conforming bid. For example, in one of our cases, several bidders for the institution did not want to purchase a certain subsidiary and excluded it from their bids. In another case, an unsuccessful bidder rejected FDIC's proposed loss-sharing structure and instead submitted a bid to service an asset pool of classified loans and purchase only performing assets.

[3]Of the 206 bids received, 111 bids were submitted by 32 bidders for the 20 First City Bancorporation banks.

FDIC received 34 nonconforming bids for 12 of our sampled cases. We found that 14 nonconforming bids contained minor differences from DOR's marketing strategy, while 20 nonconforming bids contained major differences from DOR's marketing strategy. In four cases, the nonconforming bid was determined to be the least costly resolution alternative with one nonconforming bid containing major differences from DOR's marketing strategy. For the 34 nonconforming bids, DOR was able to evaluate all but 5 bids in the cost test. For the nonconforming bids, which DOR could not evaluate, we found that DOR provided a reasonable explanation for not analyzing these bids. For example, in one case, DOR staff was unable to accurately determine the cost of providing the tax indemnification requested by the bidder. Appendix II contains summary information on the bids received by FDIC.

Uncertainties in Resolution Decisions

In making resolution decisions, the FDIC Board is faced with a great many uncertainties. The uncertainties include, among others, unanticipated gains or losses from subsequent receivership asset sales and lawsuits filed against or on behalf of the failed bank that can affect actual recoveries on assets estimated at the time of the resolution decision. While many failed bank's assets placed in receivership are sold during the first 5 years, 10 years or more may pass before asset sales are essentially completed and a receivership is terminated. Asset recoveries are subject to uncertainties because of changing economic and market conditions affecting asset values. Such changes could affect actual recoveries from the level estimated at the time of the resolution decision.

Other sources of uncertainty in resolution decisionmaking are the estimates of uninsured deposit payouts and future proceeds under loss-sharing and other asset disposition agreements. In addition, bridge bank decisions by FDIC involve unique uncertainties.

Estimates of Uninsured Deposits

As discussed earlier in this report, the amount to be paid to depositors is a key factor in determining the cost of resolution of a failed bank. Even so, FDIC did not have precise estimates of insured and uninsured deposits at the time of the resolution decision because of the complexity of the insurance coverage rules and the related inadequacy of bank financial information about deposit accounts that is reported to FDIC. Various aspects of uninsured deposits are further discussed in appendix V.

Before the passage of FDICIA, FDIC or the acquirer of the entire deposit base of a failed bank generally paid uninsured depositors. This mitigated, to a large extent, FDIC's need for an accurate determination of the insurance status of deposits in making a resolution decision. Under FDICIA, however, the cost of paying off uninsured depositors must be considered in least-cost decisions; and payments of uninsured deposits are generally restricted to cases where such payments can be made consistent with a least-cost resolution decision.[4]

Depending upon available time and information, FDIC generally relied, and continues to rely, on an on-site review to determine the insurance status of deposit accounts. The information reported by banks basically only identifies those accounts over $100,000, which may or may not be covered under the complex deposit insurance rules. Our review of sampled major resolution cases showed that following the enactment of FDICIA, FDIC has experienced difficulty in accurately determining the amount of uninsured deposits held by a failing bank. In some cases, FDIC has had to wait until a bank had been closed and resolved to make this detailed account determination and has had to rely primarily on the bank's reported deposit information.

In October 1992, DOR changed its method of accounting for uninsured deposits to enable FDIC to better estimate this amount at the time the FDIC Board evaluates resolution alternatives. The new method, based on FDIC's historical resolution experience, is to estimate uninsured deposits for which no insurance determination can be made from available information as 15 percent of the total account balances for which an insurance determination is not completed.

Another factor that contributes to FDIC's difficulty in completing timely estimates of uninsured deposits is that all depositors can continue to make account deposits and withdrawals until the bank is closed. In one of the resolution cases we reviewed, the failing bank experienced deposit

[4]In early 1992, the FDIC Board was concerned about the possibility of the systemic risk that could result from runs on failed banks if uninsured depositors sought to withdraw their deposits. FDIC sought to minimize the impact of losses to uninsured depositors by providing to such depositors advance dividends approximating the amounts estimated to be recovered from asset sales. This provided uninsured depositors with immediate access to a portion of their uninsured funds while DOL commenced asset sales. The concerns of the Board did not materialize in 1992, even though cumulatively, uninsured depositors absorbed about $80 million of estimated losses in the 1992 resolutions, which is about 2 percent of the losses expected to be incurred by the deposit insurance fund. The Board's concerns about uninsured depositors may also have been somewhat mitigated by the passage in August 1993 of depositor preference legislation, which places uninsured depositors ahead of unsecured creditors. Now, in the event of a bank failure, FDIC would make payments to uninsured depositors before it would make payments to unsecured creditors, which thereby reduces uninsured depositors' risk of loss.

outflows of about $180 million, including about $14 million in uninsured deposits, in the 2 weeks before its closure. DOR officials told us that changes of this magnitude occurring so near to the time of the FDIC Board's resolution decision could not always be reflected in DOR's cost evaluations of resolution alternatives.

The FDIC Board is likely to continue to use the new method because of difficulties in determining the amount of uninsured deposits. These difficulties are caused not only by the withdrawals that can occur before a failing bank is closed, but also by the complexity of the insurance coverage rules and the associated limited reliable account information at failing banks, as discussed in appendix V.

Estimates of Proceeds Under Loss-Sharing Agreements

For five of the seven resolutions of major banks we reviewed, FDIC offered a loss-sharing agreement to potential acquirers. In each of the five cases, FDIC documented the assumptions about estimated costs under loss-sharing agreements in terms of an expected upper limit of losses. The limits were on the basis of potential credit losses generally associated with the assets covered by the agreement rather than on FDIC's historical experience of losses on such assets when covered by loss-sharing agreements. The bases of FDIC's assumptions were reasonable in that FDIC's experience in loss-sharing agreements is limited. However, we believe that a more certain basis for estimating costs associated with loss-sharing agreements would come from historical data. As discussed in a later section of this chapter, FDIC is taking steps to improve its assumptions about the costs of its loss-sharing agreements.

Bridge Bank Decisions

While only two resolutions in 1992 involved a bridge bank, they raise policy issues for FDIC.[5] In deciding to operate a failing bank as a bridge bank until an acceptable acquirer can be found, the FDIC Board is faced with a number of uncertainties. Some risk is inherent in bridge banks because of changing market conditions during the time FDIC operates the bank while seeking an acceptable acquirer. Bridge banks are also based on assumptions about expected market interest and likely bid price rather than on actual bids.

In addition, an issue arises as to whether uninsured depositors in the bridge bank should be expected to share in any losses from bridge bank operations at the time it is sold to an acquirer, considering uninsured

[5]One of these two resolutions involved First City Bancorporation of Texas, which represents 20 banks.

depositors were already required to assume a share of estimated losses when the bridge bank decision was made. In the two bridge bank decisions, FDIC did not place uninsured depositors at further risk. The two bridge banks were operated by FDIC for quite brief periods, generally less than 6 months, with the banks' activities remaining essentially the same during the period. Consequently, little if any additional BIF losses were estimated because of bridge bank operations and uninsured depositors were not assessed any further amounts. FDIC has decided on a case-by-case basis how to handle the resolution of bridge banks, including whether uninsured depositors should be expected to share in any additional losses. FDIC intends to use its experience with bridge bank decisions to develop relevant policy positions on these issues.

FDIC Has Taken Steps to Improve Least-Cost Decisionmaking

During 1993, DOR initiated efforts that may help to reduce some of the uncertainties in resolution decisions. Using as a baseline the AVR results used in its 1992 resolutions, DOR has started to track and compare actual asset recovery results to estimates of asset recoveries used to calculate resolution costs. Specific tracking and monitoring provisions were included in resolutions with loss-sharing agreements so FDIC could ascertain its proportionate share of losses as well as recoveries. DOR plans to use the results of these efforts in creating "feedback loops" to compare actual results with earlier estimates and improve its asset valuation techniques.

The development of such feedback loops, if effectively implemented, should eventually enhance FDIC's process for resolving banks. DOR officials advised us that they have also taken initiatives to work with liquidation staff to improve data relating to asset disposition activities to enhance DOR's decisionmaking.

DOR has also started to analyze its 1992 resolution transactions as a basis for developing more sophisticated, actuarial-based asset valuation models in the future. DOR anticipates such models will facilitate the development of additional strategies and transaction alternatives for resolving a failing bank.

Conclusions

During 1992, FDIC continued to improve its evolving resolution process. These improvements, as reflected over the 22 resolutions we reviewed, have enhanced FDIC's documentation of the cost assumptions underlying the resolution decisions.

FDIC's initiatives to improve estimates related to uninsured deposits and loss-sharing agreements should allow the agency to further improve its resolution process and provide a better analytical base for future resolution decisions. We are encouraged that FDIC continues to analyze its resolution process to reduce uncertainties in loss estimates, bid evaluations, and loss-sharing agreements. We believe that these efforts, if effectively implemented, should increase the level of certainty in resolution decisionmaking.

FDIC Needs to Improve Its Documentation of Marketing Strategies

While FDICIA requires FDIC to resolve failed banks in the least costly manner, the statute does not prescribe the way in which FDIC must consider the realm of all possible resolution methods. Thus, FDIC has considerable discretion to construct a strategy by selecting from among a large number of variations within the basic resolution methods in any given resolution. Because the marketing of failed banks is central to FDIC's consideration of possible resolution methods, we reviewed the marketing strategies FDIC used in 22 resolutions to determine the agency's rationale for those strategies and the process used to implement these strategies.

In most cases, we found the agency's rationale for judgments made in selecting marketing strategies was not documented. FDIC marketing decisions, which determine how failed banks are presented to potential acquirers, may affect the range of alternatives considered by FDIC in its least-cost test. FDIC needs to document its marketing decisions, specifically addressing the agency's rationale for selecting certain resolution methods and rejecting others. We believe that DOR should submit its marketing decisions to the FDIC Board for consideration to provide greater assurance to Congress and the public that resolution costs are being minimized.

FDIC Did Not Document Its Rationale for Marketing Strategies

Generally, FDIC identifies resolution alternatives through its process for marketing a failed bank to potential acquirers. The marketing effort requires FDIC to develop a strategy for marketing the failed bank. The marketing strategy includes selection of the basic resolution methods as well as the packaging of a failed bank's assets, deposits, and other liabilities for sale. Further, FDIC's marketing strategy typically includes determining whether (1) FDIC will offer loss-sharing or other incentive agreements on certain assets and (2) some poor quality assets will not be offered for sale.

Deciding How to Market a Failed Bank

DOR's interim procedures, set out during 1992 and finalized in 1993, require DOR to consider alternative resolution methods. According to DOR officials, DOR considers two basic resolution methods in deciding the marketing strategy for a failed bank—purchase and assumptions (P&A) involving essentially the whole bank or some portion of a bank's assets and insured deposit transfers (IDT).[1] The P&A resolution methods are discussed further in chapter 1.

[1]FDIC may also temporarily control and operate a failed bank as a bridge bank until an acceptable acquirer is selected and approved.

The starting point for DOR's development of a marketing strategy is the division's development of an information package containing financial and nonfinancial information about the failed bank. Also, DOR's guidance requires the division to review the structure of the bank, competition and economic conditions in the geographical area, past resolutions, and any other relevant information. From these reviews and interviews with bank and regulatory officials, DOR officials attempt to identify the bank's problem assets as well as the market interest in acquiring those assets.[2] DOR officials may decide to exclude from the bid package certain risky assets that the officials believe the market would not purchase. In this case, FDIC would transfer the risky assets to the receivership, and DOL would sell them piecemeal to the private sector. In addition, DOR may decide to offer an incentive to bidders to encourage the purchase of certain problem assets. The incentive could be an agreement whereby FDIC (1) would allow the acquirer to return (or "put back") assets to FDIC if the acquirer could not sell the assets in a prescribed period or (2) would share in losses incurred in the acquirer's disposition of problem assets.

For failures of regional banks (that is, banks with assets under $1 billion), DOR's regional office analyzes alternative resolution methods and submits its recommended marketing strategy to Washington, D.C., for review and approval. DOR officials in Washington said that they review the marketing strategy recommendation to ensure that it is reasonable and that alternative resolution methods have been considered. The approved marketing strategy is presented to those attending the bidders conference. DOR also includes the approved marketing strategy in the decision package provided to the FDIC Board for its consideration in making the least costly resolution decision.

DOR senior officials in Washington develop the marketing strategy for failures of major banks (that is, those with assets over $1 billion) with input from regional office personnel. As in the regional banks, DOR officials said that they consider and analyze alternative resolution methods. However, unlike regional banks, DOR does not have a process that requires the formal review and approval of recommended marketing strategies before presentation to the FDIC Board to ensure that it is reasonable and that available resolution methods have been considered.

Although the least-cost provisions of FDICIA require FDIC to choose between resolution alternatives on the basis of cost, the passage of FDICIA did not

[2]Problem assets can be defined as those loans that are nonperforming or for which repayment is otherwise in doubt. Riskier assets may include those loans in which the collateral values have fallen below the amount owed or real estate owned by the failing bank from foreclosures on defaulted loans.

change the basic types of resolution methods available to FDIC or FDIC's general preference for whole bank P&AS, which limit the assets liquidated and held for liquidation by FDIC. For the 5 years before FDICIA's enactment, FDIC officials preferred the whole bank approach, and a senior FDIC official told us that the agency's marketing strategy during that period sent a clear and explicit message to potential acquirers that FDIC was primarily interested in receiving bids for whole bank resolutions. FDIC officials told us that they continue to prefer this resolution approach when it is feasible and complies with FDICIA requirements.

In 1992, a number of conditions worked against whole bank P&AS. FDIC officials told us that, during 1992, acquirers were generally not interested in whole bank transactions because of the poor condition of the economy and the banking industry. Also, banks were reluctant to purchase additional assets because of regulatory capital requirements. Furthermore, the FDIC officials said that the rise in the failure of financial institutions, which began in the late 1980s, had saturated the market for failed bank assets.

Making Decisions About Failed Bank Assets

Some bank assets may be withheld from the bidding process or offered on an optional basis if FDIC officials believe, on the basis of their knowledge of the market, that those assets are of little or no interest to potential acquirers. FDIC officials stated that bank assets may also be withheld because of the uncertainty of the value of the assets, which would most likely result in a lower bid premium from potential acquirers. Such assets have included real estate acquired by a failed bank as the result of foreclosures on defaulted loans, known as real estate owned, and loans with real estate collateral whose value has fallen below the delinquent loan balance, known as in-substance foreclosure loans.

Fixed assets, which include the bank's premises, may also be of little interest to potential acquirers, according to FDIC officials. For example, in 15 of the 22 cases we reviewed, we found that real estate owned and/or in-substance foreclosure loans were not offered for sale to the market. In the remaining seven cases, we found six in which real estate owned was offered on an optional basis (in the remaining case, the bank had no real estate owned or in-substance foreclosure loans). Also, for 16 of our 22 cases, the bank's fixed assets were offered to bidders on an optional basis. Concerning the remaining six cases, FDIC retained the bank's fixed assets in three cases and in the remaining three cases, the fixed assets were included in the bid offering and ultimately passed directly to the acquirer.

FDIC officials continue to believe that better returns on failed bank assets ultimately result if those assets are managed by the private sector rather than the government until they are eventually sold. Accordingly, FDIC devises its marketing strategies so that, to the extent possible, more assets are passed to the private sector. In some cases, FDIC may offer incentives for an acquirer to purchase certain assets. For example, FDIC may offer loss-sharing agreements, which assign FDIC a portion of losses the acquirer incurs in disposing of these assets within a prescribed period. Loss-sharing agreements typically cover assets that FDIC has found difficult to liquidate during receivership, such as commercial loans delinquent for 90 days or more. Other techniques that FDIC used to keep assets in the private sector in a market made resistant by the many bank failures of the 1980s included the establishment of FDIC-assisted "collecting banks," which provided the acquirer with capital to dispose of problem assets, and "put-back" agreements, which enabled acquirers of assets that did not sell within a prescribed period to return those assets (put them back) to FDIC.

For the 1992 resolutions we reviewed, we found that loss-sharing agreements were the most frequently offered incentive, particularly for resolutions of major banks. In five of the seven major resolutions we reviewed, FDIC determined that the resolution alternative having the loss-sharing incentive was the least costly resolution alternative. (For all 22 cases we reviewed—including resolutions of major and regional banks—8 offered loss-sharing agreements as an incentive.) The loss-sharing agreements for the five major banks covered total assets of approximately $4.4 billion, about 26 percent of the banks' combined $16.8 billion in assets. The loss-sharing agreements extended, on average, for 5 years.

FDIC Cannot Assure That Marketing Procedures Minimize Resolution Costs

Because the process by which FDIC selects its marketing strategy can affect the range of alternatives that are later considered in applying the least-cost test, we reviewed FDIC's selection of marketing strategies in 22 resolution cases. In our review, we sought to determine the reasons, in each case, for FDIC's selection of marketing strategies, including any exclusions of assets from bid solicitations and any offerings of loss-sharing agreements. We also sought evidence that the marketing strategies selected were consistent with achieving the purpose of resolving failed banks in the least costly manner.

FDIC has considerable discretion to construct a strategy for resolving a failed bank in the least costly manner. However, in most cases we reviewed, we could not determine how FDIC arrived at its marketing strategy. Of the 22 resolution cases we reviewed, only 4—all regional banks—contained documentation of the rationale for resolution approaches selected for marketing purposes. None of the seven resolution cases involving major banks had such documentation. We believe that without such documentation, FDIC cannot demonstrate, with great assurance, that the fullest effect of FDIC's statutory mandate to choose the least costly resolution is being met.

The FDIC Office of Inspector General (OIG) also reported concerns regarding DOR's documentation of its marketing decisions.[3] OIG indicated that DOR's case files did not contain sufficient documentation to support the selection of resolution types or the rationale for offering an asset agreement. OIG also indicated that DOR would be unable to support the steps taken or alternatives considered in designing individual resolution strategies and would have difficulty assuring Congress and other parties that all potential avenues of resolution were considered. In July 1993, OIG reported that DOR had corrected many of the problems identified in its earlier audit report and was in the process of developing policy memorandums and procedure manuals to address OIG's concerns.[4]

DOR officials agreed with us that better documentation of the rationale for marketing strategies is needed and assured us that they will address this issue. They also advised us that they are continuing to improve the evolving resolution process, and the diminishing resolution workload of the agency should give them an opportunity to further improve the process.

Conclusions

We were unable to determine from available documentation how FDIC arrived at the marketing strategy for most of the 22 resolution cases reviewed. We found, in most of the cases we reviewed, documentation was inadequate for us to determine FDIC's basis for making one or more of the following decisions before soliciting bids: (1) selecting or rejecting various resolution methods, (2) offering or not offering loss-sharing agreements on certain assets, or (3) deciding not to offer poor quality assets for sale. Because these marketing decisions determine how failed banks are

[3]FDIC, Office of Inspector General, Audit of Division of Resolutions Operational Controls, March 30, 1992.

[4]FDIC, Office of Inspector General, Follow-Up Audit: Division of Resolutions Operational Controls, July 16, 1993.

presented to potential acquirers, they may affect the ranges of alternatives considered by both FDIC and potential acquirers.

As a practical matter, FDIC must make judgments regarding how best to offer an institution for sale. However, to give the fullest effect to FDIC's statutory mandate to choose the least costly method, we believe that marketing decisions should be thoroughly documented and reviewed. In particular, the record in each resolution should address those methods that are potentially available and explain the agency's rationale for selecting some and rejecting others. Further, the record should reflect a formal review of the marketing strategy developed to ensure that all resolution possibilities have been considered. We believe that thoroughly documenting the record in each case would both enhance the quality of FDIC's decisionmaking and provide greater assurance to Congress and the public that resolution costs are being minimized.

Recommendations

We recommend that the Acting Chairman of FDIC require DOR to

- document the rationale for its marketing strategies for resolving all failing or failed banks and
- submit the documented record of the marketing strategies to the FDIC Board for its consideration in making the least-cost resolution decisions.

Agency Comments and Our Evaluation

FDIC provided written comments on a draft of this report, which appear in appendix VI. FDIC concurred with our findings and recommendations and said that FDIC is updating DOR's internal operating procedures in response to our recommendations. If implemented as described, we believe that the changes should provide FDIC better assurance that its statutory mandate to choose the least costly method is being met.

Summary Data on GAO Sample of FDIC's 1992 Resolutions

This appendix includes profile information on the DOR resolutions included in our sample. Table I.1 shows data from our analyses of the 22 sampled resolutions, and table I.2 reflects the assets retained by FDIC in the sampled resolutions.

Table I.1: GAO Sample of FDIC's 1992 Resolutions

Dollars in millions

DOR office/Failed bank	Date closed (1992)	Total assets[a]	Total deposits[a]	Uninsured deposits[a]	Estimated fund loss[b]	Loss to uninsured depositors (Yes/No)
Boston:						
Atlantic Trust Company	January 30	$21	$21	$[c]	$4	No
Vanguard Savings Bank	March 27	407	408	9	102	No
Winchendon Savings Bank	August 14	66	64	4	5	No
Plymouth Five Cents Savings Bank	September 18	216	182	5	10	No
Guaranty-First Trust Company	November 13	326	313	4	55	Yes
New York:						
American National Bank of NY	January 24	21	20	[c]	2	No
Summit National Bank	April 3	90	89	[c]	23	Yes
Brookfield Bank	May 8	73	69	[c]	26	Yes
The Union Savings Bank	August 28	577	560	14	54	Yes
Sailors and Merchants Bank and Trust Company	December 11	33	32	[c]	6	No
San Francisco:						
United Mercantile Bank and Trust Company, N.A.	March 20	29	28	1	8	Yes
The Bank of Beverly Hills	April 3	119	115	12	30	Yes
The Financial Center Bank, N.A.	May 4	243	226	17	63	Yes
Statewide Thrift and Loan Company	November 13	10	9	[c]	2	No
Huntington Pacific Thrift and Loan Association	December 4	42	37	[c]	4	Yes
Washington:						
Dollar Dry Dock Bank	February 21	4,028	3,733	57	574	No
American Savings Bank[d]	June 12	3,613	3,011	119	422	Yes
First Constitution Bank	October 2	1,638	1,361	15	122	No
The Howard Savings Bank	October 2	3,612	3,392	49	117	No
First City Bancorporation, Texas[e]	October 30	8,789	7,879	410	507[f]	Yes-4, No-16[g]
Heritage Bank for Savings	December 4	1,316	985	33	15	No

(continued)

Dollars in millions

DOR office/Failed bank	Date closed (1992)	Total assets[a]	Total deposits[a]	Uninsured deposits[a]	Estimated fund loss[b]	Loss to uninsured depositors (Yes/No)
Meritor Savings Bank	December 11	4,501	3,197	225	c)	No
Total	**n/a**	**$29,770**	**$25,731**	**$974**	**$2,151**	**n/a**

[a]Values as noted by DOR before the bank's closing.

[b]Loss reflects DOR's initial estimated cost of resolution, as reflected in its cost analysis.

[c]Indicates values less than $1 million. (Uninsured deposits at these seven banks totaled $1,667,000: Atlantic Trust Company, $2,000; American National Bank of NY, $0; Summit National Bank, $535,000; Brookfield Bank, $823,000; Sailors and Merchants Bank and Trust Company, $135,000; Statewide Thrift and Loan Company, $24,000; Huntington Pacific Thrift and Loan Association, $148,000. The estimated fund loss for Meritor Savings Bank was $0.)

[d]American Savings Bank data include its subsidiary Riverhead Savings Bank.

[e]First City Bancorporation data include all 20 banks.

[f]FDIC's initial resolution decision to bridge the First City Bancorporation banks was estimated to cost $507 million. However, the final sale to acquirers of the banks resulted in no loss to the Bank Insurance Fund.

[g]On the October 30, 1992, resolution of the First City Bancorporation banks, FDIC imposed losses on uninsured depositors in 4 of the 20 banks. Uninsured depositors at the remaining 16 banks suffered no loss.

Source: GAO analyses of 22 sampled resolutions.

Table I.2: Assets Retained by FDIC in GAO Sampled Resolutions

Dollars in millions

DOR office/Failed bank	Total assets[a]	Assets retained by FDIC[b]	Least costly resolution alternative	Percentage of assets retained by FDIC[b]
Boston:				
Atlantic Trust Bank	$21	$21	P&A	96
Vanguard Savings Bank	407	402	P&A	99
Winchendon Savings Bank	66	21	P&A	32
Plymouth Five Cents Savings Bank	216	77	P&A	36
Guaranty-First Trust Company	326	313	P&A	96
New York:				
American National Bank of NY	21	21	Payoff	100
Summit National Bank	90	88	IDT w/assets	97
Brookfield Bank	73	68	IDT w/assets	93
The Union Savings Bank	577	351	P&A	61

(continued)

Dollars in millions

DOR office/Failed bank	Total assets[a]	Assets retained by FDIC[b]	Least costly resolution alternative	Percentage of assets retained by FDIC[b]
Sailors and Merchants Bank and Trust Company	33	17	P&A	53
San Francisco:				
United Mercantile Bank and Trust Company, N.A.	29	24	IDT w/assets	83
The Bank of Beverly Hills	119	119	Payoff	100
The Financial Center Bank, N.A.	243	243	Payoff	100
Statewide Thrift and Loan Company	10	3	P&A	27
Huntington Pacific Thrift and Loan Association	42	42	Payoff	100
Washington:				
Dollar Dry Dock Bank	4,028	420	P&A	10
American Savings Bank[c]	3,613	3,605	IDT—branch	100
First Constitution Bank	1,638	250	Whole P&A	15
The Howard Savings Bank	3,612	616	P&A	17
First City Bancorporation, Texas[d]	8,789[e]	8,789[e]	Bridge bank	100[e]
Heritage Bank for Savings	1,316	126	Whole P&A	10
Meritor Savings Bank	4,501	1,342	P&A	30
Total	**$29,770**	**$16,958**	**n/a**	**n/a**

Legend

P&A = purchase and assumption
IDT = insured deposit transfer

[a]Asset values as noted by DOR, before the bank's closing.

[b]Assets retained by FDIC upon closure of the bank.

[c]American Savings Bank data include its subsidiary Riverhead Savings.

[d]First City Bancorporation data include all 20 banks.

[e]In FDIC's initial resolution decision to bridge the First City Bancorporation banks, all assets were retained by FDIC. In the ultimate resolution of the banks, FDIC passed most of the banks' assets to the acquiring banks.

Source. GAO analyses of 22 sampled resolutions.

Bid Summary Data on GAO Sample of FDIC's 1992 Resolutions

This appendix includes profile information on the bids received by DOR for our sample. Table II.1 shows bid summary data on the 22 sampled resolutions, and table II.2 is an analysis of nonconforming bids on GAO sampled resolutions.

Table II.1: Bid Summary Data on GAO Sampled Resolutions

DOR office/Failed bank	Least costly resolution alternative	Winning bid nonconforming (Yes/No)	Total bidders	Total bids	Total nonconforming bids	Nonconforming bids not evaluated
Boston:						
Atlantic Trust Company	P&A	Yes	1	1	1	0
Vanguard Savings Bank	P&A	Yes	2	3	1	0
Winchendon Savings Bank	P&A	No	4	5	0	n/a
Plymouth Five Cents Savings Bank	P&A	No	4	10	4	3[a]
Guaranty-First Trust Company	P&A	Yes	5	8	6	0
New York:						
American National Bank of NY	Payoff	No	0	0	0	n/a
Summit National Bank	IDT w/assets	No	4	4	2	0
Brookfield Bank	IDT w/assets	No	2	2	0	n/a
The Union Savings Bank	P&A	No	2	8	4	0
Sailors and Merchants Bank and Trust Bank	P&A	No	3	6	0	n/a
San Francisco:						
United Mercantile Bank and Trust Company, N.A.	IDT w/assets	No	2	2	0	n/a
The Bank of Beverly Hills	Payoff	No	1	1	1[b]	0
The Financial Center Bank, N.A.	Payoff	No	1	1	0	n/a
Statewide Thrift and Loan Company	P&A	No	1	1	0	n/a
Huntington Pacific Thrift and Loan Association	Payoff	No	1	1	1	0
Washington:						
Dollar Dry Dock Bank[c]	P&A	Yes	2	3	3	0
American Savings Bank[d]	IDT—branch	No	10	12	2	0

(continued)

DOR office/Failed bank	Least costly resolution alternative	Winning bid nonconforming (Yes/No)	Total bidders	Total bids	Total nonconforming bids	Nonconforming bids not evaluated
First Constitution Bank	Whole P&A	No	3	6[e]	4	2[f]
The Howard Savings Bank	P&A	No	3	8	0	n/a
First City Bancorporation, Texas[g]	Bridge bank	No	32	111	0	n/a
Heritage Bank for Savings	Whole P&A	No	2	2	0	n/a
Meritor Savings Bank	P&A	No	4	11	5	0
Total	**n/a**	**n/a**	**89**	**206**	**34**	**5**

Legend

P&A = purchase and assumption
IDT = insured deposit transfer

[a]In this case, a bidder submitted multiple bids, three of which were nonconforming. DOR was unable to evaluate the bidder's offer to purchase residual interest in Federal Home Loan Mortgage Corporation loans and the bank's premises with a $100,000 limitation on encumbrances.

[b]In this case, the bidder's rating was reduced as a result of an exam, and thus the bidder became ineligible to bid. Since this was the only bid received, FDIC did not perform a cost analysis.

[c]Dollar Dry Dock Bank represents the only case in which the winning bid was a nonconforming bid with major differences from FDIC's marketing strategy. (See table II.2 for an analysis of nonconforming bids on GAO sampled resolutions.)

[d]American Savings Bank data include its subsidiary Riverhead Savings Bank.

[e]The six bids received included one conforming bid, which was not evaluated by FDIC because the bidder did not have regulatory approval. This bid represented an exception; all other conforming bids in our sample were evaluated by FDIC.

[f]DOR was unable to evaluate these bids because it could not accurately determine the cost of providing the tax indemnifications requested by two bidders.

[g]First City Bancorporation data include all 20 banks.

Source: GAO analyses of 22 sampled resolution cases.

Table II.2: Analysis of Nonconforming Bids on GAO Sampled Resolutions

DOR office/failed bank	Total nonconforming bids	Degree of nonconformance[a]		Nonconforming bids not costed
		Minor	Major	
Boston:				
Guaranty-First Trust Company	6	6	0	0
Vanguard Savings Bank	1	1	0	0
Plymouth Five Cents Savings Bank	4	0	4	3
Atlantic Trust Company	1	1	0	0
New York:				
Summit National Bank	2	1	1	0
The Union Savings Bank	4	0	4	0
San Francisco:				
The Bank of Beverly Hills	1[b]	0	1	0
Huntington Pacific Thrift and Loan Association	1	1	0	0
Washington:				
Dollar Dry Dock Bank	3	0	3	0
American Savings Bank	2	0	2	0
First Constitution Bank	4	1	3	2
Meritor Savings Bank	5	3	2	0
Total	**34**	**14**	**20**	**5**

[a]We reviewed all nonconforming bids to determine the degree of nonconformance. Nonconforming bids very similar to the method described to potential bidders in FDIC's marketing strategy were considered to have a minor degree of nonconformance. Nonconforming bids significantly different from FDIC's marketing strategy were considered to have a major degree of nonconformance.

[b]In this case, the bidder's rating was reduced as a result of an exam, and thus the bidder became ineligible to bid. Since this was the only bid received, FDIC did not perform a cost analysis.

Source: GAO analyses of 22 sampled resolution cases.

FDIC's Analysis of Resolution Alternatives

This appendix describes how FDIC, as set forth in its procedures and guidance, uses its marketing activities and valuation of a failing bank's assets to evaluate resolution alternatives and to select the least costly resolution alternative.

Preparing to Market a Failing Bank

FDIC generally begins its resolution process after receiving a request for such assistance from a failing bank's chartering authority. One of its first steps is to develop a "snap shot" of the failing bank's financial condition, which provides FDIC with the initial information it needs to develop resolution alternatives.

When FDIC first begins its financial analysis of a failing bank, it develops a rather detailed breakdown of the failing bank's balance sheet items. That is, it looks at the failing bank's assets and liabilities structure to develop detailed information on the amounts and types of assets and liabilities held by the bank.

The types of information FDIC develops on each failing bank can vary based on each bank's business strategies as reflected in its asset portfolio and liabilities structure. For a failing bank primarily involved in residential or mortgage lending, FDIC would develop information on such assets based on the primary products or types of loans the failing bank offered. For example, FDIC would develop mortgage loan data based on whether the mortgages were fixed or variable rate and by the term of the mortgages, i.e., 15-year or 30-year mortgages.

FDIC does a similar analysis of a failing bank's liabilities to determine, for example, the amounts of insured and uninsured deposits and other obligations of the failing bank.

FDIC develops this analysis based on unaudited financial and other data provided by the failing bank. FDIC uses the analysis to prepare an information package on the failing bank, which it provides to potential acquirers who have expressed an interest in the assets or deposits of the failing bank.

Marketing the Failing Bank

As discussed in more detail in chapter 3, FDIC primarily relies on its business judgment, based on factors such as the economic condition of the geographical area, to determine the types of failed bank transactions it will offer to potential acquirers.

After FDIC has selected its preferred marketing strategy for resolving a failing bank, it conducts an information meeting. During the information meeting, FDIC advises the potential acquirers and discusses the FDIC terms for its selected resolution transactions. FDIC uses the information package data made available to potential acquirers as its basis to discuss the details of the proposed transaction. This allows FDIC and the potential acquirers to discuss the transaction terms based on the same financial data on the failing bank.

Typically, the transaction terms focus on the treatment of the deposits and assets held by the failing bank. That is, FDIC advises the potential acquirers whether FDIC will accept bids on the basis of all deposits or only insured deposits being assumed by an acquirer. FDIC also advises the potential acquirers about the (1) types and amounts of assets that would be passed to an acquirer as part of the transaction terms, (2) assets FDIC plans to retain, and (3) terms, such as loss-sharing agreements or other significant conditions, that are a part of the proposed transaction.

Evaluating Resolution Alternatives

As discussed in appendix IV in detail, FDIC does a valuation of a failing bank's assets to estimate their liquidation value. FDIC uses the asset valuation to estimate its potential recoveries from liquidating a failed bank's assets, which provides FDIC a basis to estimate its cost to liquidate a failing bank. FDIC also uses the asset valuation results as its basis for evaluating resolution alternatives. Besides a liquidation, resolution alternatives available to FDIC are the bids it receives for a failing bank.[1]

Determining Resolution Costs

FDIC's payments to insured depositors represent its primary resolution cost. Because of their senior claims, secured creditors of a failed bank represent another resolution cost because FDIC typically honors their claims. Potential payments to uninsured depositors and general creditors represent additional elements of resolution costs. FDIC payments to these claimants depend on the resolution results.

FDIC (taking the place of insured depositors it has already paid), uninsured depositors, and general creditors share in any resolution proceeds estimated to be realized generally after payments to insured depositors and secured creditors have been recognized. FDIC generally can make full payments to uninsured depositors at the time of the resolution decision

[1]FDIC can also choose to create a temporary bridge bank before making a final resolution determination.

only as a part of a least costly resolution. For transactions involving the transfer of only the insured deposits to an acquirer or a FDIC payment to only insured depositors, uninsured depositors may receive an advance payment on their uninsured amounts, depending on proceeds FDIC expects to receive from the resolution transaction and any post-resolution asset disposition activities.

FDIC, uninsured depositors, and general creditors generally share in resolution proceeds based on the relative or proportionate amount of their claims. That is, if each group held a $1 claim against a failed bank, each would have a basis to claim one-third of the proceeds FDIC realizes from the failed bank.[2]

Proceeds from asset disposition—either at the time of the resolution decision or subsequent to asset liquidation activities—represent FDIC's major source of funds for offsetting costs to resolve a bank. In evaluating resolution alternatives, FDIC must compare its estimated liquidation cost to any bids received. On the basis of this analysis, FDIC is to select the least costly alternative for resolving a failed bank.

[2]In August 1993, depositor preference legislation was passed that places uninsured depositors ahead of general or unsecured creditors. Now, in the event of a bank failure, FDIC would make payments to uninsured depositors before it would make payments to unsecured creditors.

An Overview of FDIC's Asset Valuation Process and Methods

During 1992, FDIC used three methods to estimate the present value of assets held by failing banks. Two of the methods, Total Asset Purchase and Assumption (TAPA) asset review and the Asset Valuation Review (AVR), were based on on-site reviews of sampled asset files and records at the bank. FDIC developed and used TAPA before FDICIA's enactment and during the first half of 1992. FDIC developed and implemented AVR in the second half of 1992. When liquidity problems, such as limited ability to meet depositors' fund withdrawals or legal problems at the failing bank, precluded an on-site review, FDIC used a third method. This method was a statistical research model based on data from FDIC's recovery experience for six broad asset categories of assets held by small banks that failed between 1986 and 1990. The research model was also used by FDIC for comparison purposes in assessing TAPA or AVR results.

On-Site Reviews

The TAPA and AVR models are similar in some ways. TAPA calculates asset values based on a sample of assets taken on-site, estimating by various categories of assets the effect of current market conditions and risk factors on the book value of the sampled assets for each category. AVR, like TAPA, involves an on-site review of assets; however, the assets are drawn from more narrowly defined categories, thus enabling greater specificity and reliability in book value adjustments. FDIC officials said that TAPA provided a reasonable basis to pursue the agency's pre-FDICIA resolution strategy, which focused primarily on arranging whole bank resolution transactions. The AVR model provides a more detailed analysis of a failing bank's assets and also pays more attention than TAPA to how cash flows from different asset categories may change over time. FDIC officials said the AVR model has improved FDIC's ability to evaluate whole bank and other resolution methods.

Asset Valuation Review

The Division of Resolutions (DOR) is to use AVR in the least-cost analysis of transactions proposed for resolving a failing bank. FDIC starts its AVR by using failing bank asset values from the information package, which essentially extracts information from the bank's unaudited financial statements.

AVR includes several methods to compute the net present values of the assets held by a failing bank. Net present-value analysis provides a basis to estimate the current value of assets that will be disposed of in the future. DOR is to use the model to estimate the anticipated net cash recoveries that FDIC could obtain through the liquidation of all the assets of a failing bank.

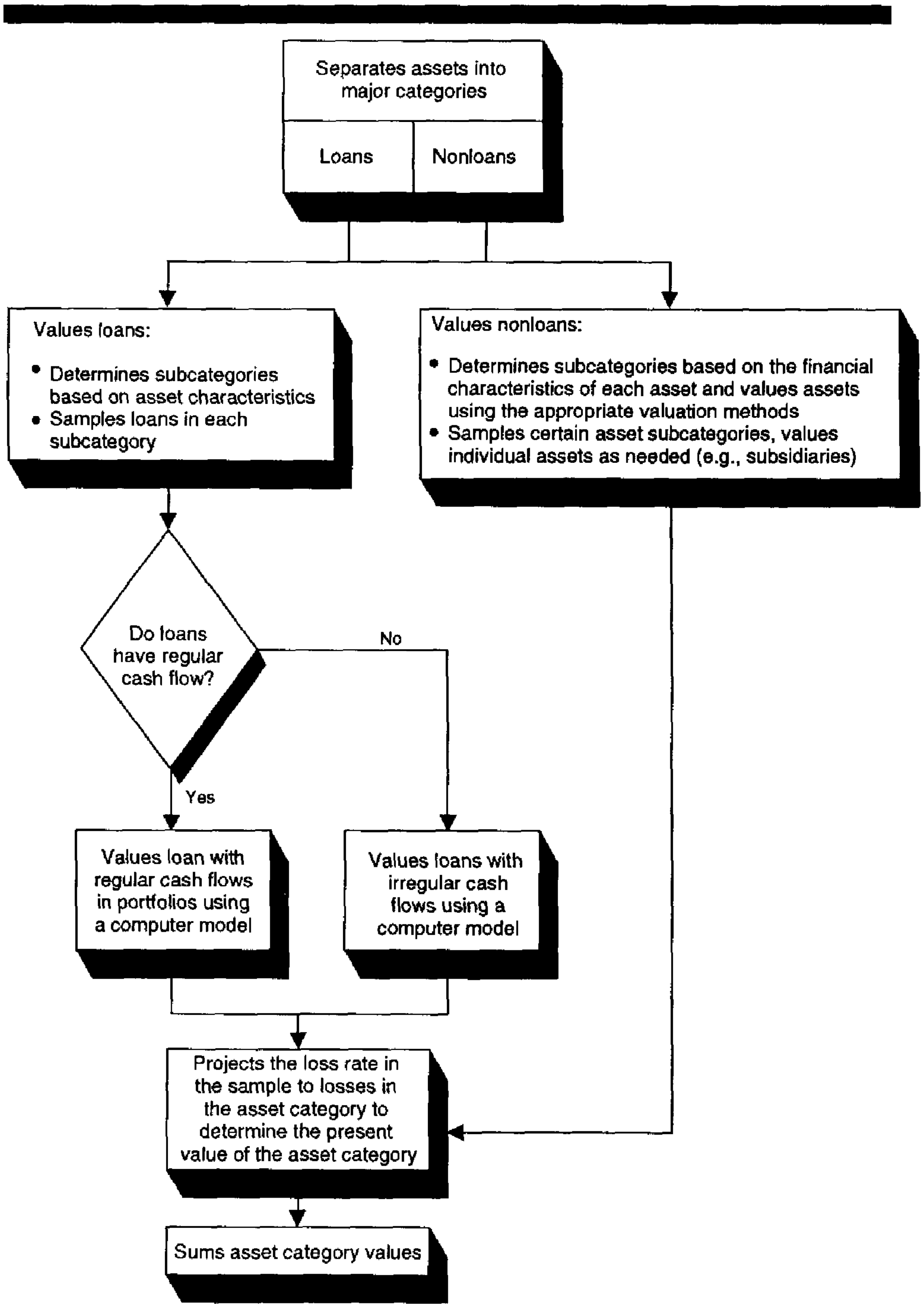
DOR does not rely exclusively on financial models to estimate the present value of all assets held by a failing bank, since this can be done by other techniques. Certain assets, such as cash and federal funds sold, are to be valued through a reconciliation of the bank's records. Securities are priced to market by contacting brokers or using publications such as the Wall Street Journal. These activities are to be done as part of AVR and determine the current values of those assets, usually as of the date of the financial data used to develop the information package. The results are to be incorporated into the final AVR report.

DOR uses the financial models to estimate the present values of other assets, such as loans, real estate owned, and subsidiaries. AVR relies on selecting samples of assets based, for example, on the type, value, and performance status of loans and other characteristics. On the basis of analysis results for each sample of assets, AVR projects the loss for all similar assets not included in the sample.

The financial models use one of two approaches to value assets, depending on how FDIC anticipates the assets will be sold. One sales method involves selling groups of homogeneous assets, such as one-to-four family residential mortgages, by securitizing the loans and selling them in secondary markets. The model computes the present value of such assets using a discount rate built on the secondary market's required yield, essentially market rates current at the time of the valuation, adjusted for risk-related factors (i.e., problems with loan documentation, underwriting standards, or the remaining maturity of the loans). As discussed below in more detail, the model then estimates the present value of the proceeds of the sales of the securitized loans, based on when the sales are expected to occur, plus any proceeds FDIC realized while it held the loans until they were sold, using a discount rate reflecting FDIC's cost of funds.

The second sales method assumes FDIC's recoveries come from any payments a borrower continues to make until a loan is paid off or, ultimately, the sale of the underlying collateral. AVR estimates the present value of the cash recoveries expected to be realized from managing and eventually selling such assets as nonperforming loans, real estate owned, fixed assets, and subsidiaries. Figure IV.1 shows FDIC's typical approach to valuing assets.

Figure IV.1: FDIC's Typical Approach to Valuing Assets



Source: GAO analysis of FDIC procedures.

DOR uses several sources, as needed, to develop its assumptions related to current market rates, loan default and prepayment rates, holding periods, and asset recovery rates. DOR uses data obtained from the following sources to complete its present-value analyses using the AVR model:

- Information on the quality and marketability of assets obtained through reviewing records maintained by the failing bank.
- Local market condition data obtained by contacting other financial institutions located in the same general area as the failing bank.
- Real estate property values obtained from local real estate appraisers.
- Personal property values for assets such as cars, boats, and mobile homes from industry reference material.
- FDIC asset liquidation results obtained from DOL Consolidated Field Offices responsible for managing and selling assets from failed banks.

The AVR analysis can be done by a team composed of FDIC staff or by contractors. In addition to establishing and maintaining documentation of asset valuations, AVR procedures require an overall summary that identifies the methodologies and assumptions used during the asset valuation process.

DOR does not use the AVR model to estimate costs associated with contingent liabilities, which can include financial instruments such as letters of credit and lawsuits filed against or on behalf of the failing bank. A separate team composed of FDIC liquidation and legal staff analyze the failing bank's contingent liabilities and estimate FDIC's potential costs associated with those liabilities. DOR incorporates these results into its AVR report and in its cost analyses of resolution alternatives.

AVR Discounting Methodology

FDIC takes a two-step approach in applying discount rates to determine the present value of an asset. FDIC first estimates the price at which it could sell the asset. FDIC does this by estimating the amount and timing of any net income, or yield, the property may provide to the asset purchaser. Using a private-sector discount rate based on current market rates adjusted for credit risks or other risks associated with the asset, FDIC adjusts the value of the asset to determine a selling price that would provide an investor a rate of return similar to rates on comparable assets.

FDIC then determines its present value of the asset sale. This involves accounting for the asset's value as discounted in the first step—the asset's estimated selling price—and any net income FDIC may earn while holding the asset until it is sold. FDIC uses its cost of funds, which is pegged at the U.S. Treasury Bill rates, as the discount rate in its calculation to determine its present value or net realizable value of the asset.

This two-step calculation estimates the asset's present value based on FDIC liquidation of the asset. We believe that FDIC's process for selecting and using discount rates overall appears reasonable.

Research Model

The research model uses (1) statistical methods to analyze a failing bank's financial data and (2) asset disposition experience of the Division of Liquidation (DOL) to estimate the values and losses associated with assets held by a failing bank. The historical DOL asset disposition experience essentially serves as a proxy for market and risk determinations done in TAPA and AVR. The analysis is done off-site, using financial data from the failing bank. FDIC officials said that the research model, which is based on FDIC's historical experience, provides less reliable results than the models based on the on-site reviews, which focus on current conditions found at the specific bank to be resolved. The research model served as the sole source of valuation only when necessary due to legal problems, such as fraud, or liquidity problems at the failing bank, which prohibited on-site reviews of assets. FDIC most often used the research model as a rough means of checking results from TAPA and AVR asset valuations.

The research model also calculates the present value of the expected recoveries or cash flows from the assets owned by a failing bank. However, the data it analyzes are drawn from regulatory filings such as call reports, i.e., report of condition rather than from on-site reviews. The statistical model, which estimates the amount and timing of cash flows and recoveries that could be achieved, is based on FDIC's recovery experiences for six broad categories of assets held by small banks that failed between 1986 and 1990. The model uses a discount factor based on FDIC's cost of funds to complete the net present-value calculation.

FDIC's Treatment of Uninsured Depositors Under FDICIA: Losses Imposed More Frequently, in Larger Amounts

FDICIA's least-cost provisions generally require FDIC to close banks using methods least costly to the insurance fund.[1] Under FDICIA, depositors over the $100,000 insurance limit and general creditors have been more likely to incur part of the losses that formerly have fallen almost exclusively to the Bank Insurance Fund (BIF).

The effect of least-cost resolutions on uninsured depositors is already becoming apparent during FDIC's first year of implementing the FDICIA requirements. In the 3 years before the passage of FDICIA, uninsured depositors absorbed losses in about 14 percent of the total bank failures. Subsequent to FDICIA, uninsured depositors absorbed losses in 49 percent of the total bank failures. At the time of resolution, FDIC estimated that losses absorbed by uninsured depositors in 1992 bank failures would be approximately $80 million; this amounted to about 2 percent of total expected losses in all 1992 failed banks.

Pre-FDICIA Resolutions: Uninsured Depositors Generally Received de Facto Insurance Protection

Before FDICIA, uninsured depositors generally received de facto insurance protection when banks failed. This occurred because (1) resolution methods primarily focused on transferring to a healthy bank all deposits held by a failing bank and (2) regulators believed that such protection provided to uninsured depositors, and in some cases general creditors, helped to maintain the stability of the banking system.

FDIC resolution officials explained that before FDICIA, the Federal Deposit Insurance (FDI) Act, as amended, permitted FDIC to pick any resolution option that was less costly than an insured depositor payoff and liquidation of the failed bank's assets. That is, until FDICIA passed, FDIC did not have to consider all available alternatives for resolving a failing bank. This allowed FDIC greater flexibility to pursue its preferred resolution strategies. In the years just before FDICIA, FDIC often focused on arranging whole bank resolutions whereby a healthy financial institution assumed all of the deposits along with all or almost all of the assets and other bank liabilities. As a result, uninsured deposits were assumed by the buying bank, thereby providing de facto insurance protection.

While uninsured deposits generally received protection, they represented a small fraction of deposits at time of failure. Table V.1 shows that in the 3 years preceding FDICIA, 1989 through 1991, uninsured deposits were about

[1]FDICIA provides for a systemic risk exception to the least-cost requirement if a finding is made that compliance with the least-cost requirement would have serious adverse effects on economic conditions or financial stability and that a more costly alternative would mitigate such adverse effects.

$2.5 billion, or about 2.7 percent, of the $92.8 billion in total deposits held by failed banks.

Table V.1: Uninsured Deposits Held by Banks at Time of Failure, 1989-1991

Dollars in millions

Year	Number of resolutions	Total deposits	Total uninsured deposits	Percent deposits uninsured
1991	127	$53,832	$1,423	2.6
1990	169	14,837	715	4.8
1989	207	24,097	348	1.4
Total	**503**	**$92,766**	**$2,486**	**2.7**

Source: FDIC Division of Resolutions Report on Treatment of Depositors, December 31, 1992.

In the 3 years before the passage of FDICIA, FDIC imposed losses on uninsured depositors in 69, about 14 percent, of the 503 failed banks that it resolved. It is not clear to what extent the coverage provided to the uninsured depositors in the resolved institutions may have increased losses to the deposit insurance fund.

Before FDICIA, FDIC did not evaluate all of the bids that it may have received for the deposits and/or assets of a failing bank. FDIC grouped the bids it received generally based on the amount of a failing bank's deposits and assets that would pass to a potential acquirer. FDIC would then begin its bid evaluation process starting with bid offers to acquire essentially the whole failing institution. If FDIC evaluated one or more whole bank bid offers that it estimated would be less costly than an FDIC liquidation of the failing bank, it would select the whole bank offer it estimated to be the best offer. It would not evaluate any other bids it may have received for a portion of the failing bank's assets.

By following this bid evaluation process, FDIC did not always evaluate all bids it may have received for a failing bank. Therefore, it has no historical record that can be used to determine whether its resolution methods achieved the least-cost resolution of a failed bank. Additionally, our review disclosed that FDIC's records did not provide a basis for determining whether coverage extended to uninsured depositors, as occurs in a whole bank transaction, increased or helped to reduce FDIC's costs to resolve a failing bank.

Treatment of Uninsured Depositors Under FDICIA

Under FDICIA, FDIC has less discretion in providing coverage to uninsured depositors. FDIC can cover the losses that could be imposed on uninsured depositors in a post-FDICIA resolution (1) only as a part of the least costly resolution decision and (2) when the amounts received from acquirers are sufficient to cover the losses that could have been imposed on the uninsured depositors.[2]

During calendar year 1992, FDIC resolved 122 failed banks with deposits totaling about $41.2 billion. Uninsured deposits, like before FDICIA, represented a relatively small portion of deposits at the time of resolution. In 1992, uninsured deposits were $1.4 billion, or about 3.4 percent, of the $41.2 billion in deposits held by the failed banks.

Since FDICIA passed, FDIC has modified its bidding process. FDIC now accepts bids generally on the basis of an acquiring institution assuming either insured deposits only or all deposits. FDIC, to the extent possible, also evaluates all bids received on a failing institution.

As a result of the application of the least-cost provisions, FDIC has most frequently arranged transactions whereby an acquirer assumes either the insured deposits only or all deposits of a failed bank. In selecting the least costly method to resolve a failing bank, compared to prior years, FDIC, during 1992, more frequently chose methods that resulted in uninsured depositors experiencing some losses.

Generally, FDIC depositor treatment at resolution has resulted in the transfer of most deposits to a healthy institution. In 111 of 122 resolutions, or 91 percent, FDIC transferred either all deposits or insured deposits.

In 62 of the 122 resolution transactions completed, uninsured depositors were made whole as part of the resolution transactions—FDIC did not impose any losses. In the remaining 60 resolution cases, FDIC imposed initial losses, referred to by FDIC officials as "haircuts," on uninsured

[2]FDIC has interpreted the least-cost requirements of FDICIA as prohibiting the passage of uninsured deposits to the assuming institution unless that particular resolution represented the least costly resolution alternative. Further, section 13(c)(4)(E) of the FDI Act specifically prohibits the FDIC from taking any direct or indirect action after December 31, 1994, concerning any insured depository institution that would have the effect of increasing losses to any insurance fund by protecting depositors for more than the insured portion of their deposits or creditors other than depositors. This subparagraph makes clear that FDIC is not prohibited from engaging in P&A transactions where uninsured deposits are acquired, as long as the loss to the fund on those deposits is no greater than the loss that would have been incurred concerning those deposits had the institution been liquidated. FDIC, as required by this subparagraph, issued final regulations implementing this provision on December 22, 1993. As noted in the preamble to the rule, FDIC believes that subparagraph (E) is "subsumed in the more general least-cost provisions of section 13(c)(4)(A) and has no independent operative effect." (58 Fed. Reg. 67662, Dec. 22, 1993.)

depositors ranging between 13 percent and 69 percent of uninsured amounts. FDIC determined the amount of loss or haircut applied to uninsured amounts on a bank-by-bank basis. FDIC based the rate of haircuts it applied to uninsured amounts held by each bank on the (1) estimated recoveries it expected to realize from selling assets held by each failed bank, (2) deposit premiums paid by acquiring institutions, and (3) uninsured depositors' status as a creditor. These haircuts were the initial losses FDIC imposed on uninsured depositors and totaled about $80 million. Actual losses that uninsured depositors may experience will be affected by the recoveries FDIC can achieve from asset sales.

Uninsured deposit amounts not paid by FDIC at the time it resolves a failed bank become claims against the receivership. Receivership claims entitle the uninsured depositors not made whole to share in proceeds FDIC realizes from sales of assets in receivership. While FDIC generally sells a large amount of a failed bank's assets during the first several years of receivership, FDIC may take 10 or more years before it terminates the receivership. Therefore, it may take some time before FDIC can determine the actual amount of losses imposed on uninsured depositors during 1992.

Difficulties Exist in Resolving Uninsured Deposits

FDIC has encountered operational issues in resolving uninsured deposits. Specifically, these issues are (1) FDIC difficulties in determining the level of uninsured deposits, (2) disparate treatment in uninsured depositors across resolutions, and (3) public concerns and/or confusion regarding insurance coverage.

Level of Uninsured Deposits Not Routinely Monitored and Not Easily Determined

Tracking or determining the insurance status of deposits is not a part of bank examinations. As a part of their monitoring activities, FDIC and the other federal regulators receive quarterly financial reports on the condition and income of banks as well as other financial information. While these filings report the total amount of deposits held, and the total amount of deposits exceeding $100,000, the filings do not disclose the insurance status. As discussed later, an account exceeding $100,000 may be fully insured depending, in part, on the rights and capacities of the account holders.

Further, banks do not routinely identify or monitor the insurance status of their customers' funds. FDIC's process for resolving a failing bank usually begins after it receives a notification of failure from the chartering authority. As a part of the process to resolve a failing bank, FDIC does an evaluation to determine the amounts of both insured and uninsured deposits. The time needed to complete a determination depends on the (1) size of the bank in both the volume of deposits and the number of bank subsidiaries and branches, (2) number of deposit accounts held by the bank, (3) quality of bank records, and (4) number of locations where deposit account records are maintained.

FDIC refers to the insurance determination as the aggregation of accounts. This aggregation of deposit accounts can be a laborious task. For example, in evaluating two individual accounts with the same ownership name, FDIC would have to determine whether the two accounts are held by the same individual or whether the accounts are in fact separately held by two individuals who share a common name. FDIC may rely on social security numbers or tax identification numbers to make the determination and, in some cases, review signature cards completed when the accounts were opened, to make the account ownership and insurance determination.

For joint accounts, FDIC is to aggregate the balances of all accounts with the same combination of owners irrespective of the sequence in which the owners' names are listed or the social security numbers attached to the accounts. FDIC then allocates a portion of an account balance to each account holder. Once FDIC completes allocating account balances to individuals or entities, it aggregates or totals these balances. Any such sums exceeding $100,000 are considered uninsured. FDIC cannot always make a final insurance determination on all deposit accounts prior to a failing bank's closure. In such instances, FDIC generally places deposit accounts for which an insurance determination could not be made into a "pass/hold" category. Essentially, FDIC delays making a final insurance determination on some accounts at the time a failing bank is closed and places such accounts "on hold" until a final insurance determination can be made after the bank is closed.

Further complicating the insurance determination is that depositors, insured and uninsured, can withdraw funds from their accounts up to the time of closure of a failing bank. This situation exists because the closure and resolution essentially occur concurrently. That is, a bank scheduled for closure continues its operations until it is actually closed and FDIC is appointed conservator or receiver of the failed bank. Since depositors have continued access to the funds in their accounts during this period, levels of insured and uninsured deposits held by the failing bank can vary during this period and up to the time it is closed and resolved. Between the time the FDIC Board approves a resolution alternative and the actual closure of the failing bank, the amount of deposits may vary greatly from the estimates used in pricing out resolution alternatives.

Deposits flowing out of a failing institution can also be affected by events beyond FDIC's control. In one 1992 resolution in our sample, DOR reported to the FDIC Board that a state-chartered failing bank was under a formal enforcement action by its primary regulator. About 2 weeks before the FDIC planned date for resolving the bank, the primary regulator apparently knew the failing bank could not meet the target date and required the failing bank to assess its ability to meet this capitalization requirement and to publicly release its assessment results. According to DOR staff, the bank publicly acknowledged that it could not meet the capital requirements by the target date set in the enforcement action and this acknowledgment resulted in increased deposit outflows. FDIC staff estimated that between the time the failing bank disclosed its distressed financial condition and when the resolution case was presented to the FDIC Board for approval, the failing bank experienced deposit outflows totaling about $180 million and that the level of uninsured deposits dropped about $14 million, from about $63 million to about $49 million.

During 1992, DOR staff adopted a new method for estimating the levels of uninsured deposits held by a failing institution. This new estimating method does not address or account for the changes in levels of uninsured deposits that can occur before a failing bank is closed and resolved. However, one component of uninsured deposits is the amount of deposits placed in the pass/hold category that is expected to be uninsured. FDIC is to place a failing bank's deposits in pass/hold when an insurance determination cannot be completed prior to resolution. FDIC reviewed its recent experience with deposits placed in pass/hold and found that about 15 to 17 percent eventually were treated as uninsured deposits. Beginning with resolution cases decided since October 1992, the resolution analyses treat about 15 percent of deposits placed in pass/hold as uninsured deposits and the remainder of these deposits as insured deposits for the purposes of determining (1) the least-cost resolution and (2) the proportion of the loss estimate that may have to be assumed by uninsured depositors.

Resolution of Failing Banks Can Result in Disparate Treatment of Depositors

As noted earlier, uninsured depositors can be fully covered from losses during the resolution of a failing institution only as a part of a least costly resolution decision in which the premium FDIC receives from an acquirer is sufficient to offset any losses that FDIC would have imposed on uninsured depositors had the institution been liquidated. FDIC is to treat each failing bank as a separate resolution transaction. Thus, FDIC is to decide the treatment of the uninsured depositors of a failing bank on a bank-by-bank basis.

These aspects of the least-cost provisions result in unequal depositor treatment across resolutions. For example, in 62 of the 122 resolution transactions completed during 1992, the first full calendar year since FDICIA passed, uninsured depositors were made whole as part of the resolution decision—FDIC did not impose any losses. In the remaining 60 resolution cases, FDIC imposed initial losses on uninsured depositors ranging between 13 percent and 69 percent of uninsured amounts based on the estimated losses for resolving the failing or failed institutions. Uninsured deposit amounts not paid by FDIC at the time a failed bank is resolved become claims against the receivership. These claims entitle the uninsured depositors not made whole to share in proceeds FDIC realizes from sales of assets in receivership.

In one FDIC region, three failing institutions in the same general market area were resolved at about the same time. In one instance, FDIC placed the failing institution into conservatorship, which to some extent is similar to a bridge bank, and continued to operate the institution. Uninsured deposits were transferred in total to the conservatorship bank which allowed the uninsured depositors to avoid losses. In resolving another failing institution, FDIC received bids for the institution, which resulted in full coverage of all depositors including those who were uninsured. In resolving the third institution, FDIC accepted a bid that resulted in the assumption of insured deposits only. Uninsured depositors were not fully covered at the third institution, and FDIC imposed an initial loss on the uninsured deposits of about 25 percent of the uninsured amounts in their accounts.

Similarly, uninsured depositors in failed banks within a multibank holding company received different treatment at the time of resolution. This is because FDIC handled the resolution of each failing bank as a separate transaction because each bank subsidiary was a separate legal entity. For example, resolution of the 20 First City Bancorporation banks resulted in losses being imposed on uninsured depositors in 4 of the 20 banks.

Three variables determine how FDIC will treat the uninsured in any particular resolution. First, the bank's deposit accounts may have sufficient market value to cover the uninsured pro rata share of estimated loss. In such cases, uninsured deposits are to be transferred and no haircut will result. Premiums are tied to the franchise value, if any, of the failed bank. For example, a bank may be willing to pay the premium to get a "customer list" so that it has the opportunity to sell financial services to them. Whether a bank will pay a sufficient premium is a function of matters such as its business strategy, the amount of uninsured deposits, and the stability of the uninsured depositor base.

The second variable is FDIC's estimate of the expected loss on assets. Uninsured bear a pro rata share of estimated losses resulting from asset disposal. Thus, the amount of haircut varies with the loss estimate. To illustrate, when the 20 First City Bancorporation banks failed, only 4 of the 20 failures involved haircuts to the uninsured depositors. The others had lower loss estimates. Therefore, if the existing equity and reserves exceeded estimated losses then no haircut resulted.

The third variable involves the uninsured depositors' status as creditors. Uninsured depositors are unsecured creditors. However, during the time of our study, some states had depositor preference statutes—meaning depositors stand ahead of other general creditors. The passage of depositor preference legislation in August 1993 now places all depositors ahead of other unsecured creditors. If general creditors take a larger portion of the loss, the uninsured will absorb less.

Complex Insurance Rules Hinder Consumer Awareness

The insurance status of an account can be affected by the basis on which the account is established and the rights of the account holder. Before 1967, the various "rights and capacities" in which funds were insured were determined by informal FDIC staff interpretations of the FDI Act. FDIC first promulgated deposit regulations in 1967 and substantially revised the regulations in 1990.

Under existing regulations, there are about nine different types of accounts that reflect the different rights and capacities in which funds are owned and may be separately insured. For example, a depositor may hold more than one single ownership account at an insured institution. For deposit insurance purposes, these accounts would be added together (aggregated) and insured up to $100,000 since they are maintained in the same rights and capacities. If a depositor has an individual account and a joint account with another person at the same institution, those accounts would be insured separately up to $100,000 each since the rights and capacities are different (i.e., owned in different manners).

The complexity of insurance rules makes it difficult for most depositors to independently verify that their accounts are fully protected or determine the extent to which their accounts may be protected. FDIC's aggregation of deposit accounts held by a failing bank to determine the insurance status of funds in those accounts is a complex process that FDIC, as the insurer, cannot always complete before a failing bank is closed. Thus, consumers cannot easily determine the insurance status of their funds or know when their funds could face increased risks from the potential failure of their own bank or another insured depository controlled by the same holding company (i.e., a multibank holding company).

According to FDIC, the regulations involving the insurance of joint accounts appear to be a frequent source of confusion for consumers. Regulations subject joint accounts to a two-part test to determine insurability. First, all accounts held by the same combination of owners are aggregated. Any amounts over $100,000 are uninsured. Next, the funds that pass the first test are deemed to be owned by each co-owner on a pro rata basis—unless some other basis is identified in the deposit account records. Joint account funds deemed to be owned by each individual are then aggregated. No individual is eligible for more than $100,000 in insurance for all funds held jointly with other owners at a single insured institution when owned in the same manner.

FDIC has identified situations in which joint account owners appear to have attempted to establish accounts in a manner that they thought would maximize coverage but, in fact, left much of the funds uninsured. An example of this includes cases in which several accounts were opened at one institution, but the account records would list the owners's names in a different order for some of the accounts or the social security numbers attached to the accounts would belong to different owners. Aggregating the balances of all accounts in which the owners appear in the same sequence would approach, but not exceed, $100,000. However, in determining the insurability of joint accounts, the FDIC would first aggregate the balances of all accounts with the same combination of owners irrespective of the order in which the owners' names are listed or the social security numbers attached to the accounts. Any such sums exceeding $100,000 are not insured.

Under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, FDIC may execute what is known as a cross-guarantee provision. When one bank among commonly controlled institutions fails, such as a bank within a holding company, this provision allows FDIC to offset potential losses to the insurance fund by assessing the commonly controlled institutions for the expected losses suffered by FDIC. Applying the cross-guarantee provision serves to protect the insurance fund and prevents commonly controlled institutions from concentrating losses into one bank while protecting others.

In certain circumstances, however, the cross-guarantee provision could increase the potential risks faced by uninsured depositors. For example, an uninsured depositor may deposit funds at a bank perceived to be financially strong and solvent. While the uninsured depositor's bank may be adequately capitalized, it may be affiliated with a bank, possibly in another city or out of state, that is in serious financial trouble. If the troubled affiliate fails, the losses could be significant enough that FDIC's application of the cross-guarantee provision could cause the solvent bank to fail.

The major legislative changes affecting insured institutions enacted by Congress over recent years, particularly FDICIA and FIRREA, have served to protect the insurance fund but also have the potential for exposing depositors—both insured and uninsured—to greater risks. Certain accounts, such as employee benefit plans, may experience significant reductions in insurance coverage based on the financial performance and condition of the insured institution holding such funds rather than an investment decision made by the depositor. In other instances, funds placed in a financially strong institution can face additional risks from problems that exist in financially weak affiliated institutions. With such uncertainty concerning these potential risks and the insurance status of funds placed in a bank, depositors have a greater need for adequate information to make better informed judgments on where to maintain their deposit accounts. We have no basis at this time to determine or judge whether depositors have access to or receive such types of information.

FDIC is aware of the potential that the current insurance rules can lead to confusion among the public and within the banking industry. FDIC has started making more information available through public announcement efforts, such as consumer pamphlets and a newsletter, to increase the general awareness of the current insurance rules. We have no basis at this time to determine the effectiveness of these FDIC efforts to disseminate information on deposit insurance coverage.

Comments From FDIC

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Office of Executive Director
Supervision and Resolutions

February 24, 1994

Mr. James L. Bothwell
Director, Financial Institutions and Markets Issues
United States General Accounting Office
Washington, D.c. 20548

Dear Mr. Bothwell:

This letter is in reply to your letter of February 16, 1994 to Acting Chairman Hove wherein you discuss your draft report entitled 1992 Bank Resolutions: FDIC Chose Resolution Methods Determined Least Costly, But Needs to Further Improve Its Process (Code 233387).

The FDIC is pleased that this statutorily required audit determined that the FDIC consistently chose the resolution alternative that was least costly compared to other alternatives considered as required by the Federal Deposit Insurance Corporation Improvement Act.

See p. 38.

With regard to your specific recommendations, the Division of Resolutions is in the process of updating its internal operating procedures to:

1. Require that rationale for selecting its marketing strategies for resolving failing or failed banks be documented, and

2. Require that the documented marketing strategy be presented to the FDIC Board of Directors for its consideration in making the final least-cost resolution decision.

We expect to have these requirements specifically documented in our internal procedures no later than March 31, 1994.

Finally, we appreciate the professionalism of Assistant Director Mark Gillen and his team, the audit's fairness and accuracy, as well as identifying the substantial improvements made by the FDIC during the period of the extensive field work that this audit required.

Sincerely,

John W. Stone
Executive Director
Supervision and Resolutions

Major Contributors to This Report

General Government Division, Washington, D.C.	Edward S. Wroblewski, Project Manager Vanessa Y. Adams, Deputy Project Manager James R. Black, Senior Evaluator Joe E. Hunter, Evaluator Edwin J. Lane, Evaluator Ned R. Nazzaro, Evaluator Mitchell B. Rachlis, Senior Economist Barry L. Reed, Senior Social Science Analyst Stephen J. Saks, Senior Evaluator Bonnie J. Stellar, Senior Statistician Susan S. Westin, Senior Economist Desiree W. Whipple, Report Analyst
Office of the General Counsel	Rosemary Healy, Senior Attorney
Boston Regional Office	Sally J. Coburn, Evaluator Kevin F. Murphy, Senior Evaluator
New York Regional Office	John D. Carrera, Senior Evaluator Despina Hatzelis, Evaluator
San Francisco Regional Office	Bruce K. Engle, Evaluator

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1000
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000 or by using fax number (301) 258-4066.