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Expert Analysis

Supervisory and Resolution Responses To Ongoing Bank Failures

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Regulators have identified a pattern to the frequently occurring causes of recent bank failures. While supervisory responses to these predictors of failure may not cure many of the banks that continue to trend downward in the current financial cycle, the impact of the supervisory responses will be felt by surviving banks.

The failed-bank resolution process of the Federal Deposit Insurance Corp. is the ultimate fate for troubled financial institutions that have not managed to access capital to clean up their balance sheets. However, the FDIC continues to revise aspects of failed-bank transactions in order to reduce its costs and therefore losses to the deposit insurance fund.

CAUSES OF BANK FAILURES AND SUPERVISORY RESPONSE

The FDIC's Office of Inspector General performs material-loss reviews, or MLRs, of financial institutions that fail with estimated losses to the FDIC of $200 million or more or if unusual circumstances warrant an in-depth review of the failure. This amount was increased from $25 million by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The MLRs have consistently attributed bank failures in 2010 and 2011, as available, to a handful of causes. These include:

- Unwarranted increases or concentrations in acquisition, development and construction, and commercial real estate lending.
- Asset-quality problems related to weak loan underwriting and credit administration along with related risk-monitoring practices.
- Dependency on noncore funding sources.

As early as 2008, the FDIC had cited these three indicators as the typical risk profile for a majority of community banks that became "problem" banks or failed in 2008 in an article from its Supervisory Insights journal titled "A Year in Bank Supervision: 2008 and a Few of Its Lessons."

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In prior failure cycles, the OIG identified three major causes of bank failures as inadequate corporate governance, poor risk management and lack of risk diversification, including lending concentrations. *See* Observations from FDIC OIG Material Loss Reviews Conducted 1993-2003, Audit Report No. 04-004 (Jan. 22, 2004).

Clearly, the consistent pattern identified by the agencies has raised questions regarding supervisory changes to aid in earlier detection of these problems. OIGs at the various federal bank regulatory agencies, in addition to the Government Accountability Office, regularly review MLRs and related reports in making recommendations to avoid future losses to the deposit insurance fund.

In the most recent joint report of OIGs from the FDIC, the Board of Governors of the Federal Reserve System and the Department of the Treasury, "Evaluation of Prompt Regulatory Action Implementation," dated September 2011, the OIGs recommended that the primary indicators of bank failures noted above receive supervisory emphasis in addition to the capital-based supervisory measures actively enforced by federal bank regulators.

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The joint report identified non-capital-based factors that could be used to strengthen prompt regulatory action as triggers of mandatory regulatory interventions. The factors include:

- High risk business strategies: aggressive growth, asset concentrations, out-of-territory lending and dependence on volatile funding sources.
- Risk management weaknesses: corporate governance weaknesses, such as inadequate lending policies, poor underwriting and credit administration practices, and poor executive compensation practices.
- Asset quality or earnings deterioration: credit problems involving classified and nonperforming assets, poor returns and declines in stock valuation.
- Regulatory compliance and responsiveness: lack of responsiveness, repeat findings and violations.

The findings of the September joint OIG report were substantially the same as a June 2011 GAO study and indicated that non-capital-based factors — earnings, liquidity, asset quality and asset-concentration risk — were valid and significant predictors of bank failure. Again, these factors are not novel to the current failure cycle. A 2004 FDIC OIG report also identified these factors and called for early corrective action by bank regulators to limit risk.

There has been some regulatory response in order to focus bank supervisors on non-capital-based factors, beginning as early as 2006 with the emphasis on commercial real estate lending. Federal regulators have followed with standards of practice and policy statements related to commercial real estate concentrations, revised appraisal standards and prudent commercial real estate loan workout guidelines.

There has also been a reinforced supervisory focus on credit administration, including underwriting and analysis, documentation of them in the loan files, and up-to-date borrower information.

In both the supervisory context and the applications process for banks, federal regulators have focused on asset quality and concentrations. New parameters, or old ratios with renewed relevance, are important to regulators, including asset coverage ratios and Texas ratios (nonperforming assets to capital and reserves). Levels of classified and nonperforming assets are key indicators for regulators in instituting administrative action.

Regulators also want to see asset plans with respect to nonperforming assets and capital to support those asset plans. Aggressive asset growth alone also now draws supervisory scrutiny.

Another key non-capital-based indicator is risk management. In the absence of corporate governance or the failure to follow such governance, it can be difficult for regulators to assess risk management on a supervisory basis. Accordingly, a large portion of this measurement is determined based on the effectiveness of internal controls over loan practices and administration. The "Camels" rating of management often mirrors the asset rating.

Particularly through the provisions of the Dodd-Frank Act, federal regulatory agencies are developing additional risk-management measures. As promulgated by federal regulatory agencies, proposed rulemaking has been issued with respect to incentive-based compensation arrangements, proprietary trading in hedge funds and private equity funds, known as the Volcker Rule, and the creation of the Consumer Financial Protection Bureau, to name a few.

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In the September 2011 joint OIG report, the federal bank regulatory agencies noted that their supervisory processes had been modified to account for recent trends in bank failures, including the non-capital-based components.

The Federal Reserve indicated that it has developed an "enhanced examination issues" tracking process to monitor supervisory findings. The Office of the Comptroller of the Currency stated that it was also implementing a number of changes to its supervisory process to account for non-capital-based factors. Although the FDIC did not specifically reference changes to its supervisory process, it agreed that non-capital-based standards could be appropriate.

MLRs for banks that have failed in the current cycle often cite regulatory guidelines that have been issued as supervisory responses to recent failures, including FDIC guidance on the use of volatile funding sources, and enhanced supervision of *de novo* institutions.

While no supervisory enhancement can be expected to completely mitigate substantial economic deterioration, particularly in areas of the United States and Puerto Rico where regional economic conditions have contributed significantly to failures, financial institutions can anticipate additional regulatory responses to the trends seen in bank failures over the past several years.

CURRENT BANK RESOLUTION PROCESS

Until the implementation of supervisory measures that are intended to provide for earlier identification of problem banks, the resolution process will continue to be the ultimate response for problem banks that fail to break out of the current economic cycle. While that cycle is hopefully coming to a close, bank failures can be expected to continue through 2012 and 2013.

Because the FDIC recognizes that the private sector is better at liquidating failed-bank assets — resulting in lower costs to the deposit insurance fund — and due to fewer disruptions to failed-bank customers, most transactions continue to be whole-bank purchase and assumption transactions, either for all deposit liabilities or limited to insured deposits.

Although whole-bank deals with loss-sharing were introduced late in the last major crisis, the basic premise of a whole-bank purchase and assumption transaction has changed very little. The form purchase and assumption agreement used by the FDIC sets forth the assets to be purchased and liabilities to be assumed by the acquiring institution. The purchase and assumption agreement sets forth formulas for determining the price of assets to be acquired, terms governing both the assets acquired and liabilities assumed, rights of the acquiring institution to acquire property, leases and contracts.

The agreement also delineates other duties and obligations that the acquiring institution and the FDIC will have to each other. Any assets or liabilities that are not transferred in the purchase and assumption agreement remain with the FDIC, and the FDIC will address those as the receiver for the failed bank.

Until April 2010, the FDIC provided a "stated threshold" on every transaction. Up to the amount of the stated threshold, all losses, net of recoveries, and reimbursable expenses were shared with 80 percent to the FDIC and 20 percent to the acquiring institution. Beyond the stated threshold, the FDIC absorbed 95 percent of such losses and expenses.

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The FDIC changed the loss-sharing structure for institutions above $500 million in assets in April 2010, so that the structure now provides for three tranches of bidding on each of the failed bank's commercial assets and single-family loans. The bidder bids a percentage of loss-sharing on the first and third tranche of each. The FDIC will now advise bidders at what level of losses the second tranche begins and ends, as well as the loss percentage for the second tranche.

The default rule is that the FDIC will provide an 80 percent reimbursement for losses — the acquiring institution incurs 20 percent of losses — and 80 percent of out-of-pocket expenses related to the loss-share assets in the first and third tranche. However, the acquiring institution may bid a lesser percentage of loss-sharing.

For example, in order to acquire the trophy of Riverside National Bank of Florida, Toronto Dominion Bank unit TD Bank N.A. bid a 50-50 loss-sharing split. Since then, the FDIC modified its form to facilitate bids of different loss-sharing percentages for each of the two loss-share agreements — single-family residential mortgage or commercial — and for separate asset tranches.

The purpose of the second loss tranche is to encourage bidders to manage the inherited assets better by shifting a greater amount of the losses to the winning bidder if losses cross into the second tranche. Presumably, the second loss tranche will be based on the FDIC's "intrinsic loss estimate," as valued by the agency. Bidders are provided with the specific amount of the intrinsic loss estimate a week to 10 days before bids are due.

Currently, a winning bidder will typically bid a discount on the transaction, meaning that the FDIC would pay it for engaging in the transaction. The discount can be expected to cover anticipated loan losses and other costs to the acquiring institution.

As noted in the September 2011 joint OIG report, of 190 failed banks studied between January 2006 and March 2010, there was a median asset discount of 36 percent from what the failed banks reported on their books and records. This fire-sale valuation of assets may overstate the losses, but the impact on the deposit insurance fund is the same. Acquiring institutions are able to achieve significant gains on the purchase of assets through discount bids.

In most transactions, the winning bidder has booked a one-time gain on a bargain sale, which is a taxable one-time profit from engaging in the transaction. On the other hand, bidders may bid a premium for the deposits to be acquired. Recent trends suggest that deposit premiums have decreased in amount as a percentage of deposits acquired and are often zero.

Lastly, bidders have the opportunity to offer a value appreciation instrument to the FDIC. Based on data compiled by SNL Financial LC, fewer than a dozen of the banks that have failed in the first three quarters of 2011 have been acquired where bidders offered a value appreciation instrument, none of which were under $500 million in assets.

There are other statutory and contractual protections to winning bidders. For instance, the FDIC will provide indemnification in certain circumstances. In addition, winning bidders have the ability to reprice the deposits of the failed bank. The acquiring institution also has the option to reject the contracts of the failed bank.

Recent trends in bidding on failed banks include the FDIC's movement away from loss-sharing, more opportunities for structured asset sales, and package deals for multiple failing institutions.

Loss-sharing

Loss-sharing is expensive and time-consuming for both the acquiring institution and the FDIC due to loan-compliance programs and ongoing monitoring and reporting of loss-share assets. In determining the least cost resolution of a failing institution, the FDIC considers a variety of factors, including the operating expenses of the receiver, which are greater in a loss-sharing deal because of the ongoing monitoring requirements. Accordingly, the FDIC has negotiated with winning bidders in recent transactions to accept a lump-sum discount.

In theory, the FDIC's movement away from loss-sharing will make transactions simpler and provide more immediate certainty to the transaction parties.

The number of loss-sharing deals decreased from 86.3 percent of all failed-bank trans-actions in 2010 to 66.2 percent of failed-bank deals through the third quarter of 2011, based on data compiled by SNL Financial. In theory, a movement away from loss-sharing will make transactions simpler and provide more immediate certainty to the transaction parties.

Asset sales

Although the FDIC has been separately pooling certain assets of failed banks for sale to investors since early in the current cycle, the FDIC continues to take steps to increase the pool of potential investors because it offers the least cost resolution of the failed bank's assets.

In connection with bids on the failed bank, the FDIC has pooled certain loans, which can be bid on by potential acquirers separately from the bid on the remaining assets of the failed bank. In addition, the revised purchase and assumption agreement allows buyers to acquire the loan pools within 30 days of the closing of the transaction. The loan pools, whether purchased at the time of the transaction or separately, are not covered by loss-sharing by the FDIC.

Although losses to the deposit insurance fund on failed-bank transactions and loan pools have decreased throughout the current cycle, the FDIC continues to encourage investors to bid on these structured transaction sales for loan pools and other assets.

The FDIC has most recently launched the "investor match program." This program prequalifies small investors and allows those investors to connect with larger investors to jointly participate in a structured sales transaction. The FDIC has stated that identifying more participants in structured loan sales will continue to minimize losses to the deposit insurance fund.

The FDIC has also been encouraging bidders to acquire real property or assume leases for real property earlier in the process by separately providing for them in connection with the bid rather than having acquiring institutions wait to exercise the options to acquire or lease real property available under the purchase and assumption agreement.

Package deals

The FDIC has also allowed bidding on groups of banks failing on the same day, particularly smaller banks in similar geographic areas. At least six failed-bank transactions have occurred in the first three quarters of 2011 in which the winner acquired multiple institutions in a linked bid. Combining the assets of multiple institutions piques the interest of larger purchasers and increases the competitiveness of the bids.

In addition to the broad changes designed to encourage additional bidders for failed banks, the FDIC has made a number of smaller changes to its form purchase and assumption agreement. The FDIC has also limited repeat acquisitions by an acquiring institution that has significantly increased in size, altered its product offering or moved into new markets. This oversight allows the acquiring institution's supervisory regulators to review and assess the ongoing safety and soundness of the acquiring institution.

Accordingly, institutions interested in bidding on failed banks should become comfortable with the terms of the purchase and assumption agreement and changes to the FDIC process, and they should also coordinate with the FDIC early in order to move forward with bidding.

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