Bank failures reached a post-Depression high in 1986. One hundred thirty-eight banks, including one mutual savings bank, were closed by their primary regulator; an additional seven banks needed assistance from the Federal Deposit Insurance Corporation (FDIC) to prevent them from failing.

In the first half of 1987, 100 banks failed or required assistance from the FDIC. Failures and assistance cases for 1987 are projected to reach the 200 mark by year-end. Moreover, the number of banks on the FDIC's problem bank list is at an all-time high (see figure 1), indicating that the rate of bank failures might continue at or exceed the 1986-1987 pace in the near future.

For the banking industry, the increasing incidence of troubled and failing banks reflects the changed economic environment in which they operate. Technological innovations, combined with a trend toward deregulation, have increased the competitiveness of banking markets and, consequently, have increased the degree of exposure of banks to changes in market conditions.

These factors, coupled with regulations restricting geographic and activity diversification in bank portfolios, have limited the ability of banks to protect themselves against national and regional economic shocks. In recent years, for example, depressed agricultural and energy markets have contributed to the solvency problems of an increasing number of banks in the southwest.

The FDIC has a mandate to maintain confidence in and provide stability to the commercial banking system through its regulatory and insurance functions. In addition, it is empowered to preserve that confidence and stability through the quick and efficient resolution of bank failures. The recent wave of failures has challenged the FDIC's ability to achieve these objectives. The FDIC insurance fund increasingly is threatened with illiquidity. Secondly, FDIC failure-resolution policies followed since 1984 have eroded market discipline by expanding de facto deposit insurance coverage far beyond the coverage originally intended for insured depositors.

This Economic Commentary examines the FDIC's policies for handling bank failures and discusses both the intended and the unintended outcomes of those policies. We conclude that the evolution of FDIC policies can be linked importantly to FDIC actions that have undermined market discipline on banks.

**Background**

At the lowest point in the Depression, the Banking Act of 1933 was enacted as a comprehensive reform package aimed at restoring public confidence in the stability of the banking system. Congress was concerned with eliminating the destabilizing contagion of bank runs. The banking industry was perceived as being unable to withstand "failures" in the same sense that other industries could withstand bankruptcies. Consequently, safety and soundness were placed before the "survival of the fittest" principle of market efficiency in the order of governing principles of banking. The Banking Act attempted, among other objectives, to insulate banks from some market forces by separating commercial banking from investment banking. One component of the total reform package, federal deposit insurance, was put in place to enhance the long-run stability of the banking system.

Federal deposit insurance was instituted to prevent the contagion of bank runs by protecting the small depositor. Originally, the FDIC was authorized to cover insured deposits up to a $2,500 limit. In this way, stability and public confidence in the banking system were to be restored at the grass-roots level. By offering insurance only to small depositors, it was intended that large depositors, general creditors, subordinated debtors, and shareholders still would be subject to the risk of financial loss that

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is a normal part of market discipline. Even at such low levels, however, deposit insurance was controversial because it was well understood that any insurance against the risk of failure impeded the market discipline used to detect the risk-taking behavior of depositors.¹

Deposit insurance was instituted to eliminate the contagion of bank runs, not to limit bank failures or to protect depositors.² The FDIC has been appointed receiver of a bank's affairs is reduced.

Traditionally, the FDIC collects all the bad debt and deposits of the failed bank in order to make the offer more attractive to the bidder. As a result of placing all the assets on the bidder's books, however, the liquidity of the fund is increasingly threatened. These assets are now taken accounts for two-thirds of the assets of the FDIC's $18 billion fund. Operating under the FDIC guarantees and indemnifications of the FDIC, the cost test can result in actions either not explicitly counted, or can be seriously understated in the cost test.

Problems in Application

The almost exclusive use of P&As in failure resolution, irrespective of cost or market discipline concerns, prompted a revision of policy in the 1950 Federal Deposit Insurance (FDI) Act. The cost test was used as the primary criterion for determining FDIC action in individual bank failures.

In a purchase and assumption (P&A), the FDIC offers to acquire the assets and liabilities of a failed bank for the purpose of preserving market discipline and limiting disruptions to local banking services. In many cases, however, the FDIC has failed to balance the demand for insurer-debtors, market discipline concerns were given priority over service disruption considerations throughout most of the history of the FDIC.³

The payoff better accomplishes the market discipline objectives of the FDIC's bank's assets equitably, to both deposi tors and general creditors. Under either resolution option, the FDIC guarantees and indemnifications of the FDIC, the cost test can result in actions either not explicitly counted, or can be seriously understated in the cost test.

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The erosion of market discipline, via 100 percent de facto insurance coverage, poses a long-term threat to the FDIC's ability to close banks and slowly undermines the solvency of the FDIC's insurance fund.

New Resolution Policies
The need for reform of previous FDIC policies resulted from a changed economic environment. Interest-rate volatility and the collapse of the commodities prices in the 1980s destabilized a large number of banks. When the wave of failures began (see figure 2), there was an urgent need for new ways to cope with them. Unlike failures in previous years, the 1980s failures were concentrated geographically (see figure 3). Moreover, large banks now populate the ranks of troubled and failed banks. The development of new resolution policies, for example, began in the early 1970s as a response to the first megabank failures.

The 1980s bank failure experience has led to an accelerated series of FDIC policy initiatives producing new options that are adaptations of the earlier payouts and P&As, corrected for their more obvious shortcomings. One set of policies is designed for failed banks, another set for troubled and failing banks. Although FDIC failure-resolution policies are still in the mainstream of the FDIC's explicit statutory authority, the new assistance programs for troubled and failing banks stretch the limits of that authority. These programs include modified payout, open bank assistance, capital forbearance, and bridge banks.

Modified Payout
The FDIC devised the modified payout plan in 1983 in reaction to the 100 percent de facto coverage previously associated with widespread use of P&As. As in a straight payout, the modified payout created a receivership and liquidated the failed bank's assets. However, rather than waiting until assets were sold to begin payments, the FDIC estimated the current value of the remaining assets as the basis for an immediate advance to the receiver for payments to the uninsured depositors and other claimants. In this way, the market discipline of potential losses to uninsured depositors was joined with the disruption-free timeliness of the ordinary P&A. As a result, the modified payout showed promise as a policy that could be applied equally to both large and small banks.

The modified payout first was used in 1984 as an experimental procedure with small failed banks. In the two months prior to the collapse of the Continental Illinois National Bank and Trust Company of Chicago in May 1984, nine of 17 failures involved a modified payout. Given that this procedure had been tried only on small banks, the FDIC argued that the policy was too early in its development to be applied with the requisite degree of assurance to the $33.6 billion Continental Illinois.


Open Bank Assistance
The most significant developments in FDIC policy initiatives have come under the umbrella of the open-bank assistance program (OBA). Under the FDIC Act of 1950, the FDIC obtained authority to intervene prior to a bank's failure in order to 1) facilitate the merger of a failing bank or 2) prevent failure of a bank that is deemed 'essential.' Up to this time, capital assistance to open banks to prevent failure, had been the job of the Reconstruction Finance Corporation (RFC).


12. See Section 13(c) of the Federal Deposit Insurance Act, 12 U.S.C. Section 1823(c).
expands implicit insurance coverage to stockholders and creditors of parent bank holding companies who are not protected under a P&A or a payout. The second source of criticism underscores the broad interpretation given to the essentiality test that arise from the vague definition of "community" as the role of opinion in assessing OBA. Third, the case-by-case basis on which the FDIC has bailed out large banks has propagated the general belief that certain banks are "too large to fail." If depositors act on this belief, it can lead to an undesirable concentration of assets in large banks. Furthermore, such a belief has dangerous repercussions for the effectiveness of market discipline on the risk-taking of big banks. Overall, the criticisms of OBA highlight the danger that it poses to the continued efficient operation of market discipline in the financial system.

As the number and complexity of bank failures has risen in recent years under deregulation, so has the adoption of new OBA programs. Within the last five years, the FDIC has revised the OBA guidelines twice to afford greater flexibility in preventing the closure of a failing bank. The 1982 Garn-St Germain Act removed essentiality as the prime consideration for OBA and replaced it with cost-efficiency only if the cost of assistance exceeds the cost of closing and liquidating does a finding of essentiality have to be made. The underlying design is "...to lessen the (financial) risk to the Corporation posed by such insured bank under such threat of instability." Since OBA enables the FDIC to accure losses as off-balance-sheet contingent claims, there is a strong incentive for the FDIC to infuse capital into a failing institution rather than to arrange a payout or P&A, which would require immediate recognition of losses. The replacement of essentiality with cost-efficiency as the main determinant reflects the changed role of OBA as a policy tool of the FDIC for resolving bank failures. In 1950, the OBA provision was issued as a last-resort measure intended to save a failing bank in a rural, unit-banking area in which that bank actually did provide essential banking services. Essentiality was an extreme condition that needed to be met in order to override the FDIC's noninterventionary role. By 1987, however, OBA had lost its status as a mandatory measure and has become a mainstream policy. The September 1987 bailout of First City Bancorp of Texas became the 41st case of OBA by the FDIC. Of the 41 OBAAs, 37 have occurred in the 1980s. Although the OBA policy affords greater flexibility for the FDIC to respond to failures, such assistance packages usually have some benefit for shareholders and move the FDIC closer to 100 percent de facto coverage of all parties in a failed bank, which further insulates banks from market discipline.

**Capital Forbearance**

The most recent FDIC policy initiatives have been in the area of capital augmentation. Initially, a number of techniques, such as warrants and stock worth certificates (before 1982, called income capital certificates) were employed to shore up banks. With broader interpretations of regulatory reporting methods, since 1985, the FDIC has moved toward a relaxation of capital standards for troubled institutions. Regardless of which technique is used, the problem is that troubled banks are operating with substandard capital, to remain open in the hope that the bank will eventually recover. In March 1986, the FDIC and the Comptroller of the Currency announced a joint effort to forbear regarding the enforcement of minimum capital-asset ratios below 7 percent, but above 5 percent, for sound banks with concentrations in agriculture or energy lending. A sizable proportion of recent bank failures have occurred in agriculture and energy-belt states (see figure 3). Accordingly, the capital forbearance plan is aimed at troubled banks within these regions that are seen to have been destabilized by depressed markets than by mismanagement. The plan is designed "...to provide greater operational flexibility to well-managed banks" in the hope that they will recover and thus spare the FDIC considerable liquidation costs.

Within seven months of the beginning of the forbearance plan, fewer than 20 banks had been accepted and 17 banks had been terminated acceptance into the program. The FDIC and the Comptroller of the Currency then announced a revision of their guidelines, making more banks eligible for capital forbearance. According to the Comptroller of the Currency, capital forbearance is a worthwhile program, although it has not "...covered as many banks as it should have." Consequently, the program has been broadened in two significant ways: first, capital forbearance has been made available to all insured banks whose problems are seen to be of economic conditions, not just energy and agriculture banks; second, the minimum capital-asset ratio of 4 percent has been abolished (that is, any positive capital ratio conceivably may be enough to satisfy minimum regulatory requirements). By broadening its availability, the FDIC made capital forbearance a more mainstream policy instrument, which is the same pattern previously noted in the development of the OBA programs. An early criticism of capital forbearance is that it poses the same moral hazard problem that surfaces when banks are insulated from market forces. Counter to the plan's intent, it encourages even greater risk-taking on the part of the failing institution as a last chance to gamble its way out of a weakened capital condition.

**Conclusion**

Over the last two decades, the FDIC has assumed a more active role in the resolution of bank failures and particularly in the regulation of problem banks. Each expansion of FDIC powers has occurred in response to needs that have arisen out of a changed economic or regulatory environment. Due to the increasing bank failure rate, most of the new initiatives attempt to address the problems of troubled banks before they have spread far. The FDIC has expanded the most, such as OBAs or capital forbearance, to insulate problem banks even further from market forces and arguably encourage risk-taking. This could have a perverse effect on the banking system and on the ability of the FDIC to do its job. Thus, a better balance must be achieved between market regulation and FDIC intervention needs to be more clearly addressed in future FDIC failure resolution policy initiatives.

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14. See Sprague, supra note 6, p. 28.
16. See Section 13(c), Federal Deposit Insurance Act, supra note 12.
17. An agriculture or energy bank is customarily defined as one in which 25 percent of its assets is in farm or energy lending.