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FDIC Open Bank Assistance: DOA or Ready for Revival?

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In this article, the author examines the history of open bank assistance, reviews the previous use of this recapitalization tool by the U.S. government, and discusses the Federal Deposit Insurance Corporation's articulated stance on this form of capital support.

Banks continue to fail week after week throughout the United States, and the Federal Deposit Insurance Corporation ("FDIC") continues to resolve failed banks using assistance principally in the form of the FDIC's loss-share arrangement.[1] The question many are asking is: Is there a less costly alternative in the form of open bank assistance ("OBA")? As a legal matter, OBA can only be used if it presents the least costly solution to the FDIC insurance fund when a bank is about to fail.

Nevertheless, rumors surge periodically that the FDIC may be ready to revive OBA as the number of bank failures climbs. Are these only rumors? Is OBA really DOA?

Every distressed bank, as receivership looms, becomes more interested in the OBA topic because it may represent a viable strategic alternative for recapitalization that avoids receivership. Healthy banks and investors groups find the OBA option interesting as well, because under OBA, investors in distressed banks could both: (a) rescue a bank from the brink of failure, and (b) avoid what has become in many instances a very competitive FDIC-con-

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ducted bidding process as the bank enters the zone of receivership.

The rhetoric around OBA has heated up recently. Thus, the time is right to examine the history of OBA, review the previous use of this recapitalization tool by the U.S. government and discuss the FDIC's articulated stance on this form of capital support.

HISTORY OF OBA

OBA is a distressed bank resolution method in which an insured institution in danger of failing receives recapitalization assistance *before receivership* in the form of a cash or noncash capital injection to prevent its failure. In OBA agreements, the FDIC typically provides a cash contribution to restore deficit capital to a positive level (referred to as "filling the hole"). For a large institution, the FDIC may use a note or loan to fill the hole. Additionally, the FDIC may agree to cover credit losses (similar in concept to the loss-share arrangement in FDIC-assisted acquisitions) for a specific dollar amount on a pool of assets over a specified period of time. Importantly, OBA must benefit the bank directly, so any capital flows directly into the bank and not the bank's holding company.[2]

OBA was first originated in 1950, however, prior to 1982, it was rarely used because statutory restrictions allowed the FDIC to use it only when an institution was deemed "essential" to the community. In 1982, with the passage of the Garn-St. Germain Depository Institutions Act (the "GSGDIA"),[3] the FDIC received broader authority to provide OBA. Under the GSGDIA, the essential-to-the-community test was dropped, and OBA could be provided if the FDIC's Board of Directors determined that the cost to the insurance fund would be less than the cost of liquidating the institution.

In 1987 and 1988, the FDIC completed almost 100 OBA processes. Since that time, however, several key changes put the brakes on OBA.

The following developments are generally acknowledged as the reasons for the demise of OBA:

1) The Competitive Equality Banking Act of 1987[4] authorized the FDIC to open bridge banks, which allowed the FDIC additional time to find a permanent solution for resolving a failing bank;

2) The passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989[5] eliminated tax breaks to purchasers of potentially failing institutions associated with OBA;
3) There was major criticism that the use of OBA allows shareholders to benefit disproportionally relative to other benefactors of the FDIC aid; and
4) In 1993, the FDIC was prohibited from using insurance fund monies in any manner that benefits any shareholder of an institution that failed or was in danger of failing.[6]

CRITERIA FOR OBA USE TODAY

Since 1997, the FDIC has considered OBA proposals submitted by open institutions in danger of failing based upon the following criteria:[7]

- OBA must be the least costly alternative for the insurance fund;
- Current management must be competent, have complied with all applicable laws, rules, supervisory directives and orders, and never engaged in any insider dealings, speculative practices or other abusive activity; and
- OBA must not benefit shareholders.

The FDIC may deviate from the least cost requirement only to avoid serious adverse effects on economic conditions or financial stability, or systemic risk to the banking system.[8]

RECENT OBA EXAMPLES, FDIC POSITION AND PENDING LEGISLATION

Since the beginning of the current banking and financial crisis, some large institutions were the recipients of FDIC "assistance" without failure and receivership, including Countrywide FSB, FIA Card Services N.A., Merrill Lynch Bank USA, Merrill Lynch Bank & Trust Co. FSB, Bank of America California N.A., Bank of America Rhode Island N.A., and Bank of America Oregon N.A.[9]

Some financial institutions have made formal, but unsuccessful, applications to the FDIC for OBA prior to being placed into receivership. For instance, in June of 2009, Guaranty Bank of Austin, Texas, applied to the FDIC with a formal plan for OBA. The plan was rejected, and Guaranty Bank failed on August 21, 2009.

FDIC Chairman Sheila Bair has been quoted saying: *"So-called 'open bank' assistance for large, complex banks should be prohibited. This assistance puts the interest of shareholders and creditors before that of the public."*[10]

Most importantly, federal financial reform legislation may prove a death knell for future OBA proposals. The Senate version of the bill,[11] currently the subject of legislative conference to resolve differences between the House and Senate versions, would limit the FDIC's ability to provide OBA to only those banks that have been placed in receivership and only for the purposes of winding up the institution.

WHAT'S NEXT?

Media reports indicate that OBA proposals have been presented to the FDIC recently by other institutions, including Midwest Bank. Midwest Bank is reported to have presented an OBA proposal that included an interested investor willing to inject capital conditioned upon the FDIC's approval of the OBA plan, and agreement by shareholders to boost the number of common shares from 64 million to 4 billion, which could be conveyed to a new funding source.[12] Media reports indicated that Midwest Bank presented its proposed OBA plan to the FDIC as being a less costly option, by at least $200 million, compared to putting it into receivership.[13]

Nevertheless, Midwest Bank's OBA proposal was unsuccessful. On May 14, 2010, Midwest Bank was placed into receivership, with FirstMerit Bank agreeing to assume all of Midwest Bank's $2.4 billion in deposits, paying a 0.4 percent premium and entering into a loss sharing agreement with the FDIC on $2.27 billion of assets. In its press release, the FDIC estimated the cost of the transaction to the insurance fund at $216.4 million.

It is difficult to know with certainty whether in any particular bank failure situation an OBA alternative might have been less costly to the FDIC insurance fund than a receivership followed by a purchase of assets and liabilities of the failed bank by another bank with the FDIC's loss-share arrangement.

The increasingly competitive nature of recent FDIC-assisted acquisitions presents both pros and cons for the future of OBA. The larger number of bidders will incent more potential acquirers to develop and present attractive OBA proposals to the FDIC, in an effort to preempt the bidding process. If financial returns of FDIC-assisted transactions drop too low, more players may try for the increased certainty of a negotiated/structured OBA proposal. On the other hand, the increasingly competitive bidding process is reducing the cost of receivership to the insurance fund, which may cause the FDIC to continue to utilize assisted transactions with loss-share as the least cost alternative, with the likely result of continued FDIC resistance to OBA proposals.

Moreover, OBA assistance implicitly benefits the stockholders of the bank's holding company, a politically challenging outcome and potential showstopper. There are other complex issues as well, including selling a significant equity stake in a bank subsidiary to the U.S. government and third party equity investors, which raises corporate and fiduciary issues for the Board at the holding company level.

Of course, it goes without saying that a key challenge to making a successful OBA proposal is the difficulty of *proving* that it represents the least cost option available.

Given the number of banks reportedly on the FDIC's troubled bank watch list and the very fluid environment for FDIC loss-share and the receivership process, unless OBA is expressly eliminated as an option through currently pending federal legislation, OBA is likely to continue to be a talking point in the media and among Boards of distressed banks and private investor money interested in recapitalizing a distressed bank short of receivership.

In the short term, however, the FDIC loss-share resolution process seems to be working and the competitive nature of the receivership bid process suggests the FDIC's goals are being met without tapping the OBA alternative. Directionally, at least for now, OBA seems to be more a concept than a reality. However, there is a long failed-bank-resolution-cycle left to run and, as we have seen over the last 18 months, the environment is very fluid. Accordingly, OBA will linger in the background as a strategic option on the list of most struggling banks, and it is too early to predict its imminent demise or revival.

NOTES

[1] From January 1, 2010 through the end of June, 86 banks failed. *See* Failed Bank List, *available at* http://www.fdic.gov/bank/individual/failed/banklist.html.

[2] For a fuller discussion of OBA, see the *FDIC Resolutions Handbook*, Chapter 5, Open Bank Assistance Transactions.

[3] Pub.L. 97-320, H.R. 6267, enacted October 15, 1982.

[4] Pub.L. 100-86, 101 Stat. 552, enacted August 10, 1987.

[5] Pub.L. 101-73, 103 Stat. 183, enacted August 9, 1989.

[6] *FDIC Resolutions Handbook* (citing 1993 amendments to Section 11 of the Federal Deposit Insurance Act, 12 U.S.C. 1820 *et. seq.)*

[7] *Id.,* p. 50.

[8] 12 U.S.C. 1823(c). *See also FDIC Resolutions Handbook*, Chapter 5, p. 47.

[9] FDIC "2009 Failure and Assistance Transactions," available at http://www2.fdic.gov/hsobRpt.asp.

[10] *MarketWatch.com*, March 18, 2009.

[11] Restoring American Financial Stability Act of 2010.

[12] *Chicago Tribune*, May 6, 2010.

[13] *Id.*