AMERICAN BANKER.

FDIC's Failure Role Larger Than It Likes to Admit

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NOV 2, 2011 2:29pm EDT

WASHINGTON — With the primary responsibility to sort out the affairs of dead banks, the Federal Deposit Insurance Corp. is often assumed to have the job of deciding when to pull the plug too.

The FDIC insists this assumption is false, and that the agency does not close banks &MDASH; period, full stop, end of story.

A basic legal understanding suggests the FDIC is right: a bank is almost always "closed" by the state regulator or the Office of the Comptroller of the Currency, depending on its charter. But the real story is a lot more complicated, according to experts.

"It's an eye-roller for the FDIC to assert that they don't close banks," said John Bley, once Washington state's chief bank regulator and now chair of the financial institutions group Foster Pepper. "Of course they have a material influence on that decision."

A case in point is the Oct. 21 failure of the $1.38 billion-asset Community Banks of Colorado. The failure was historic. With the state's banking regulator hoping to give the "critically undercapitalized" institution more time and allow a branch deal to raise needed cash, the Federal Reserve Board — the bank's primary federal regulator — countered that the deal would only delay the failure and make it more expensive.

Colorado's banking commissioner also argued the state's administrative laws forced him to delay action. The Fed ultimately stepped in front of the state, closing a bank for the first time ever. Sources believe federal regulators viewed the deal as sacrificing key assets without fixing the bank's underlying financial problems.

But far from being an outside player, the FDIC was apparently very involved in supervisory discussions in the bank's final days, and helped reject the bank branch deal that would have at least delayed the institution's failure.

By law, the FDIC exercises backup supervisory authority over troubled institutions, and must sign off on any recapitalization plan to repair a "critically undercapitalized" bank. The Fed and FDIC agreed the branch deal would only delay the inevitable, and make the resulting failure more expensive. By rejecting the deal, they sealed the bank's fate.

"Everybody knows that if the bank doesn't raise the capital, it's going to be closed by somebody at some point. The questions always are: How much time do you have, and whether the regulators will agree to whatever deal you would strike with potential investors," said Jeffrey Taft, a partner with Mayer Brown LLP. "The investors are going to first turn to the regulators with: 'Is this something that is acceptable?' … If the regulators aren't satisfied, they're just not going to let it go forward."

An FDIC document obtained through a Freedom of Information Act request showed the agency viewed the proposed branch deal as posing a greater risk to the Deposit Insurance Fund.

According to an application filed with regulators, Bank Midwest in Kansas City would have bought 15 of Community Banks' branches, as well as certain loans and other assets.

While the OCC, Bank Midwest's primary regulator, approved the deal, the FDIC and the Fed did not. (Bank Midwest ultimately acquired the Colorado bank's operations after it failed.)

"The results of the FDIC's analysis indicate that after the sale of the assets and transfer of deposits, the resulting institution will have a high-risk profile, inadequate capital, a large concentration of problem assets, and deficient earnings," Kristie K. Elmquist, the FDIC's acting director for the Dallas region, wrote in an Oct. 19 letter informing Community Banks of Colorado of the denial.

"In addition, "our analysis finds that the transaction would significantly diminish the value of the resulting institution and increase the risk to the Deposit Insurance Fund. This is inconsistent with" legal requirements "to resolve the problems of insured depository institutions at the least long-term loss to the DIF."

In an interview, FDIC officials said while the chartering authority is usually tasked with closing the institution, the statute requires the FDIC and others to become involved in certain cases.

"In the event that a chartering authority is not able to close the institution, the federal agencies are bound by the federal statute," said Serena Owens, associate director in the FDIC's division of risk management and supervision. She said if the FDIC had felt more comfortable about the branch deal, regulators could have given the troubled bank more time.

"If there is a potential recapitalization that may save the bank, and there is more time that's needed to reevaluate it, we have the option of extending that … 90-day deadline" under the prompt corrective action rules, she said.

"If there is a very likely chance that a reasonable deal on the table may avert the failure, certainly everybody involved is going to work to try to see that that happens. There is a lot of interagency cooperation behind the scenes in situations like that," Owens said.

Some argue Community Banks was an aberration, and the chartering agency more often has the primary role in scheduling a failure and closing the bank's doors.

While the FDIC must protect losses to the fund, some say that's not the same as closing the bank.

The FDIC is "doing the calculation of the least-cost solution, and they're shopping the bank to potential acquirers," said Rebel Cole, a finance and real estate professor at DePaul University in Chicago and a former Fed economist. "But my understanding is they pretty much always act in

concert with the primary regulator. The FDIC is the backup regulator. They do have the authority to close the bank over the objections of the primary regulator. They can revoke the bank charter. But because politics being what they are among regulators, they typically do not like to overrule the primary regulator."

The Colorado failure was hardly the only time the FDIC's actions have helped fail a bank. On rare occasions since the savings and loan crisis, the agency has used special authority to self-appoint itself as the receiver when the chartering authority didn't act.

Since the FDIC was granted self-appointment powers by a 1991 law, it has exercised that authority at least three times. Most recently, the agency appointed itself as the receiver in November 2002 for the $69 million-asset Bank of Alamo in Alamo, Tenn.

More recently, the FDIC — while not determining that a failure should occur — has been involved in deciding when it should occur.

"There is a lot going on behind the scenes, and the FDIC is normally working together with the chartering agencies on the least disruptive way, if the bank needs to be closed, to close it," said Nicholas Ketcha Jr., a former FDIC supervision director and New Jersey regulator who's now a consultant at FinPro. "The FDIC doesn't close the bank, but it plays a big part in the decision as to when the bank is going to be closed."

The FDIC has also lobbied regulators to shutter a bank due to its legal responsibility to resolve failed banks as cheaply as possible to protect the Deposit Insurance Fund. The agency fears waiting will just cause bigger losses.

"What the FDIC says publicly is that it has no legal ability to declare a bank insolvent because it is not the chartering authority," said William Longbrake, a former agency CFO and now an executive-in-residence at the University of Maryland. "The FDIC is technically correct, but their position as the insurer is ultimately controlling in almost every case.

"The FDIC does collect information and make a determination as to whether continuation of the bank is likely to be something that would reduce the potential loss to the fund, or actually increase it."

Arguably the most dramatic instance of this was in the 2008 failure of Washington Mutual Bank — the largest closure of all time. Reports make it clear that the Office of Thrift Supervision, which chartered the bank, fought with the FDIC to keep Wamu open. But the agency pushed for the thrift's closure because it wanted to limit the failure's potential losses.

"It's pretty well understood that the Office of Thrift Supervision did not believe that Washington Mutual should be closed, but that there was a reasonable plan of recapitalization in process," said Longbrake, who was a vice chairman at Wamu.

"The FDIC felt that the risks to the fund of a large failure were too great, and they feared that if the bank was allowed to continue working on a recapitalization plan, that things would get worse and the loss would get much deeper to the insurance fund."

The FDIC's hand was also seen in another Colorado failure earlier this year. In suing regulators over its closure, the former managers of United Western Bank in Colorado targeted the FDIC along with the OTS, its chartering agency, arguing the thrift was closed while still viable and the two regulators did not give full consideration to its pending recapitalization plan.

Even though a judge ultimately excused the FDIC, ruling that only the OTS could be sued, the suit had argued that the FDIC's classification of its deposits as "brokered" helped speed up the failure. (While the case is still pending, the OTS has since been eliminated by Congress and its duties given to the OCC, which is now defending the case.)

The FDIC "can certainly have an impact on capital and certainly influence a chartering authority's decision on whether the financial institution is solvent," said Bley. "They wield significant influence."

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