Congressional Research Service
Informing the legislative debate since 1914

IN FOCUS

January 23, 2015

Bank Failures and the FDIC

This *In Focus* introduces the Federal Deposit Insurance Corporation's (FDIC's) process for resolving failing FDIC insured banks. It also identifies policy issues Congress may consider related to the FDIC, including new resolution authority established by the Dodd-Frank Act (P.L. 111-203).

Overview of Bank Failures

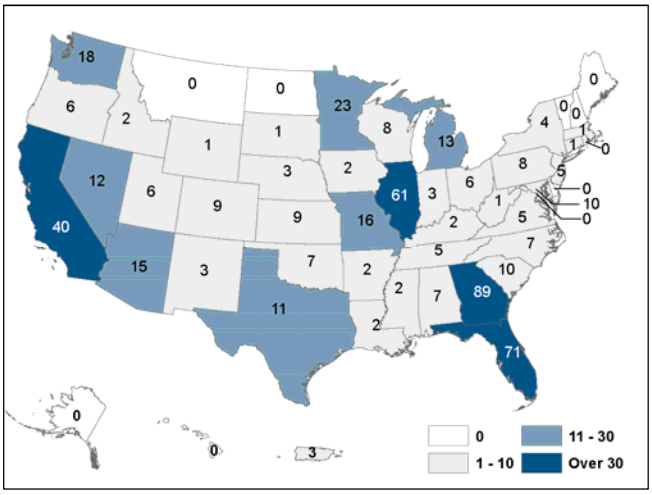
Banks fail for many reasons, although most trace back to the management of bank resources, resulting in a bank's inability to meet liquidity or capital requirements. Liquidity refers to the ability of a bank to meet cash flow needs, including deposit withdrawals by its customers. Capital (equity) is the difference between assets and liabilities. A bank's capital helps absorb losses on loans, securities purchased by the bank, and other assets. When a bank's capital situation deteriorates such that it fails to meet minimum regulatory standards, the bank's primary federal regulator is required to take Prompt Corrective Action (PCA). Regulators typically issue PCA letters advising the bank on specific actions it must take to restore itself to financial health. When a critically undercapitalized bank fails to meet PCA requirements, its regulators often will place the bank into either a conservatorship or receivership administered by the FDIC.

For most bank failures, the FDIC is appointed as the receiver by the bank's primary regulator. The Office of the Comptroller of the Currency (OCC) is the primary regulator for nationally chartered banks. The Federal Reserve regulates its state chartered member banks. The FDIC regulates state chartered banks that are not members of the Federal Reserve. The FDIC does not issue bank charters.

Bank Failures, 2007-2014. There were 510 bank failures between 2007 and 2014. **Figure 1** illustrates bank failures by state, including Puerto Rico. The rising default rates on real estate loans and the declining value of mortgage-backed securities were major drivers of bank failures. Bank failures collectively represent $504 billion in deposits and $692 billion in assets. The largest bank failure was Washington Mutual Bank with $188 billion in deposits and $307 billion in assets. Most depository institutions that failed were relatively small banks.

Deposit Insurance Fund (DIF). Deposit insurance guarantees repayments of deposits at a bank up to the insured limit, $250,000. It is intended to prevent bank runs and reduce the risk of systemic failure of the banking system. Banks pay deposit insurance premiums to the FDIC, which maintains the DIF to meet its obligations of insuring deposits and resolving failed banks. Since the start of federal deposit insurance in 1934, all depositors have been made whole up to their insured limit after a bank failure. The FDIC deposit insurance is backed by the full faith and credit of the United States. While the DIF was funded to its statutory limit before the recent financial crisis, it was rapidly depleted by bank failures during the crisis. The DIF balance was at its lowest at the end of 2009 with a negative balance of $20.9 billion. The DIF balance has recovered to $54.3 billion as of September 30, 2014. The fund has remained self-financed and did not require federal support during the most recent financial crisis.

Figure 1. Bank Failures by State from 2007 to 2014



Source: CRS with data from FDIC, Failures and Assistance Transactions reports.

Overview of the Resolution Process

As receiver of a failed bank, the FDIC evaluates all possible resolution alternatives and selects the one that is least costly to the DIF. The FDIC used three main resolution methods between 2007 and 2014: (1) Purchase and Assumption transactions, (2) Deposit payoffs, and (3) Deposit Insurance National Bank assumptions. Another method, bridge banks, is a type of purchase and assumption resolution method the FDIC has used on a limited basis to resolve large or complex failing banks.

Purchase and Assumption Agreement (P&A). The most commonly used resolution method is the P&A with an acquirer. The FDIC seeks bids from qualified bidders for the failed bank's assets and the assumption of certain liabilities, including deposits, and accepts the bid that is judged least costly to the DIF. Based on how the P&A is structured, in most instances, the Acquiring Institution (AI) purchases a majority, if not all, of the assets and assumes all or some of the deposits and certain other liabilities of the failed bank. For many of the transactions, the FDIC has offered asset discounts and entered into loss sharing agreements on certain assets purchased by the AI. With loss

sharing agreements, the FDIC agrees to absorb a portion of the losses on the sale or the write-downs on the value of certain assets, mainly loans. Loss sharing agreements can reduce the immediate negative impact to the DIF by limiting the amount of losses absorbed by the DIF when asset prices are declining. The FDIC offered loss sharing for 304 of the 510 resolutions between 2007 and 2014.

Deposit Payoffs. If no viable P&A AI can be found, then the FDIC typically deploys a deposit payoff. In a deposit payoff, the FDIC ensures that the customers of the failed institution receive the full amount of their insured deposits. The FDIC retains the assets of the failed institution in its corporate capacity as receiver. The assets are eventually sold to maximize the recoveries to the DIF, uninsured depositors, creditors, and owners of the failed bank.

Deposit Insurance National Bank (DINB). If there are no viable AIs and the FDIC determines that a deposit payoff would be disruptive to the community and financial markets, then the FDIC might use a DINB to resolve a failed bank. In a DINB, the FDIC establishes a new national bank with a charter from the OCC. By law, a DINB charter can be as long as two years, with optional one-year extensions for three more years, but in practice FDIC has chartered a DINB with limited life and surrenders the charter within a few weeks. A DINB resolution allows failed-bank customers a brief period to move their deposits to other banks. The bank has no capitalization requirements. The FDIC retains the majority of the assets in its corporate capacity as the receiver and eventually sells them.

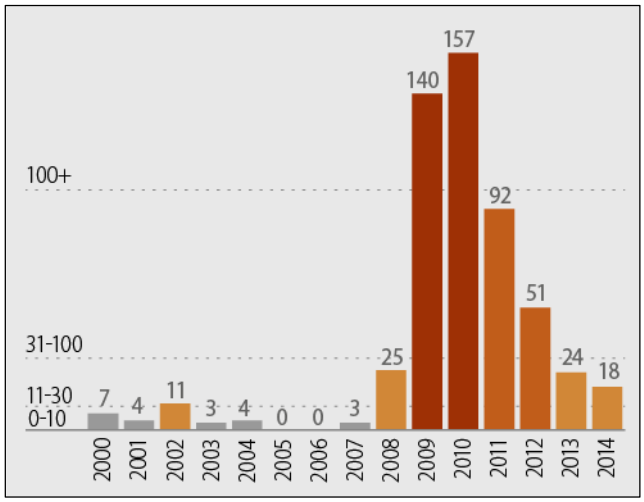
Bridge Banks. In a bridge bank P&A, the FDIC initially acts as the acquirer and receiver until the bank is marketed to external parties. The FDIC may establish bridge banks to resolve large or complex failing banks in which more time is needed than a typical DINB resolution. By law, a bridge bank is initially chartered for two years, with optional one-year extensions for three more years. The FDIC used bridge banks on a limited basis during the most recent financial crisis.

Policy Issues in the 114th Congress

Dodd-Frank raised the statutory minimum of the DIF funding ratio from 1.15% to 1.35% and the assessment base was changed. How insurance premium assessments are apportioned between the largest banks and smaller banks is subject to debate. The FDIC's stated goal of building up the DIF balance to 2.0% of the assessment base could place an additional burden on banks, but it may reduce the risk of drawing on a federal backstop.

Some Members of Congress have expressed concern about the declining number of community banks. At this point, the decline is primarily due to consolidation, not failures. Bank failures have continued to decline since the height of the crisis, see **Figure 2**. The total number of FDIC insured banks decreased by 2,092 between January 2007 and September 2014. Of this decrease, 1,586 were due to consolidations and 506 were due to failures.

Figure 2. Bank Failures by Year from 2000 to 2014



Source: CRS with data from FDIC, Failures and Assistance Transactions reports.

Notes: The graph above reflects bank failures for the full years from January 2000 to December 2014; it does not reflect FDIC assisted transactions.

Some have also questioned whether certain provisions of the Dodd-Frank Act solve or exacerbate the perceived problem of "too big to fail." Too big to fail has remained a concern since the crisis, as assets and deposits at the largest banks have continued to grow. In 2014, the four largest insured depository institutions each held $1.6 trillion to $2.6 trillion in assets. Certain provisions in Title I and II of the Dodd-Frank Act responded to too big to fail by establishing new resolution authority for FDIC, addressing specific vulnerabilities of the resolution process that surfaced during the crisis. Certain Title I provisions require each U.S. chartered Bank Holding Company (BHC) or foreign banks that have U.S. operations with total assets exceeding $50 billion to submit a resolution plan (living will). Other firms deemed likely to present systemic risk to U.S. financial stability, regardless of size, could also be required to submit a living will. A living will must describe the company's strategy for rapid and orderly resolution in the event of material financial distress or failure of the company.

On August 5, 2014, the FDIC and the Federal Reserve identified specific shortcomings with the 2013 resolution plans for the 11 largest banking organizations that will need to be addressed in the 2015 submissions. In the event that a resolution under Title I poses a systemic risk to the financial stability of the United States, Title II grants the FDIC new resolution powers to use a bridge financial company as a secondary option to resolve a non-depository institution. No failures have been resolved under Title II to date. Living wills are also expected to provide guidance for resolution under Title II.

Raj Gnanarajah, rgnanarajah@crs.loc.gov, 7-2175

IF10055