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FAILING BANKS

Lessons Learned From Resolving First City Bancorporation of Texas

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The Honorable Alfonse M. D'Amato, Chairman
The Honorable Paul S. Sarbanes
Ranking Minority Member, Committee
on Banking, Housing, and Urban Affairs
United States Senate

In fewer than 5 years, the Federal Deposit Insurance Corporation (FDIC) was called upon twice to resolve the financial difficulties of the federally insured banks of the First City Bancorporation of Texas, Inc. (First City). In April 1988, FDIC provided about $970 million of assistance in an attempt to restore First City's financial health. Four years later, in October 1992, the Office of the Comptroller of the Currency (OCC) and the Texas Banking Commissioner determined that the two largest First City banks were insolvent and imminently insolvent, respectively. FDIC was appointed receiver of all 20 First City banks. At that time, FDIC estimated the second resolution would cost the Bank Insurance Fund (BIF) about $500 million. In January 1993, FDIC reviewed bids for the 20 failed banks, announced the sale of the banks, and revised its estimated BIF cost to zero. Lawsuits were filed by First City against FDIC, OCC, and the Texas Banking Commissioner. The lawsuits asserted, among other things, that federal and state banking regulators acted without regard to due process and illegally and unnecessarily closed a solvent banking organization. In June 1994, FDIC and First City signed a settlement agreement that provided for payments by FDIC exceeding $200 million in cash and assets to be paid out of the receiverships of the First City banks and termination of all related litigation. In FDIC's view, the settlement is based on the following two principles: (1) the 1992 resolution of the First City banks would be at no cost to BIF, and (2) FDIC would not receive any money in excess of its actual costs incurred in connection with the resolution of the First City banks. Any settlement reached between the parties cannot be consummated until it is approved by the bankruptcy court. FDIC officials anticipate a decision on the settlement agreement in early 1995.

At the request of the former Committee Chairman, we reviewed both resolutions of the First City banks. This report addresses the following four questions:

- Regarding the first resolution, why did the FDIC Board of Directors decide to resolve First City's financial difficulties in 1988 by providing financial assistance instead of using other available resolution alternatives?

- Regarding the second resolution, why did FDIC's estimate of BIF costs to resolve First City at the time of the 1992 failure differ so much from the estimate when the banks were sold in 1993?
- What, if any, additional cost to BIF is expected to result from the second resolution of First City?
- What lessons does the First City experience offer relevant to the assistance, closure, and resolution processes?

As agreed with the Committee, we focused our review on First City's largest bank (located in Houston) and its second largest bank (located in Dallas) because the financial difficulties of these banks resulted in the failure of First City's 18 other banks. Our objectives, scope, and methodology are further discussed in appendix I.

Results in Brief

In the first resolution in 1988, FDIC decided to provide $970 million in financial assistance to First City as part of a method of resolution known as open bank assistance. This method generally involves recapitalizing and restructuring a banking organization, as well as attracting new management. FDIC chose this method of resolution because it was determined to be less costly than liquidating the banks in the event of insolvency, which FDIC projected to be likely. FDIC estimated BIF costs to liquidate the banks to be about $1.74 billion, as opposed to the $970 million estimated for open bank assistance. Another alternative resolution method would have been to sell the banks if they became insolvent. However, at the time, FDIC did not believe that it would be able to find acceptable acquirers with sufficient private capital to restore the banks to long-term viability.

In the second resolution in 1992, the estimated BIF costs to resolve First City at the time of failure differed from the estimated cost at the time of sale primarily because FDIC made its first cost estimate without the benefit of having actually received bids from potential acquirers. Instead, to facilitate the orderly resolution of the banks, FDIC placed them under its control for about 3 months and operated them as bridge banks[1] while it arranged a sale. According to FDIC officials, the FDIC Board of Directors relied on its "best business judgment" in estimating BIF costs at the time of the banks' failures. In arriving at the $500 million loss estimate, the Board considered loss estimates that ranged from $300 million to over $1 billion in making its least-cost resolution determination.

[1]FDIC may establish a bridge bank to temporarily take control and operate a failed bank until an acquirer can be found and an orderly resolution can be arranged.

At the time of the sale of the banks in January 1993, FDIC officials expressed "astonishment" at the market interest in the banks and projected that the second resolution would result in no cost to BIF. Indeed, FDIC estimated that the proceeds of the sale would exceed its costs for the second resolution by $60 million. FDIC's no-cost projection for BIF remained intact even after lawsuits were filed on behalf of First City's shareholders. In June 1994, FDIC and First City signed a settlement agreement whose basic tenet is that BIF will incur no loss. The bankruptcy court must approve any settlement reached between the two parties.

The First City experience offers valuable lessons for both FDIC as the insurer, and FDIC and the other federal agencies that regulate depository institutions, in how to better assist, close, or otherwise resolve troubled institutions. For example, in the case of First City, the economic assumptions used as a basis to determine the likely success of open bank assistance would have been more realistic if FDIC had drawn upon the shared judgment of all the involved regulatory agencies. The 1988 financial assistance may also have had a greater chance for success if FDIC had (1) required First City to establish better controls over lending practices and other bank activities, and (2) tailored its assistance agreement with First City to provide tighter control over the flow of funds through dividends and other payments to protect against the undue erosion of bank capital. Regarding the closure decisions, OCC could have better supported its decision to close First City-Houston in 1992 by ensuring that its examination reports and underlying workpapers were clear, well documented, and self-explanatory. FDIC resolution officials could also have benefitted from having earlier access to information on OCC examiners' preliminary findings regarding the financial condition of the largest First City bank. This could have given FDIC more time to consider the widest possible range of available resolution alternatives and a means of verifying its own valuation of the First City assets.

Evolution of Resolution Activities on Behalf of First City Banks

By the late 1970s, the First City Bancorporation of Texas, Inc., through its subsidiary banks, had a high concentration of loans to the energy industry in the Southwest United States and was regarded as a principal lender in that industry. In the early and mid-1980s, when the energy industry experienced financial difficulties, so did First City. By 1986, First City was reporting operating losses. First City, its regulators, and FDIC recognized that many of the subsidiary banks could not survive without major infusions of capital. These parties agreed that the capital needed for long-term viability could not come wholly from the private sector due to the financially strained condition of the Southwest's economy and banking industry.

A chronology of events leading to FDIC's open bank assistance in 1988 and the final resolution of the First City banks in 1993 appears below. A description of changes in various legal authorities over the same period, 1987 to 1993, is contained in appendix II.

The First Resolution: Open Bank Assistance

After considering available alternatives, FDIC and First City entered into a recapitalization agreement—commonly referred to as open bank assistance—that called for First City to reduce its subsidiary banks from nearly 60 to about 20. The agreement also required the creation of a "collecting bank"[2] to dispose of certain troubled assets held by the subsidiary banks. The open bank assistance included a $970 million capital infusion from FDIC along with $500 million of private capital raised by the new bank management to restore First City's financial health. As part of the agreement, FDIC received $970 million in preferred stock of the collecting bank. FDIC also received a guarantee, from both First City Bancorporation and the subsidiary banks, for $100 million payable in 1998 toward the retirement of the collecting bank preferred stock.[3]

The recapitalized First City banks embarked on a short-lived aggressive growth policy that resulted in First City banks' assets increasing from about $10.9 billion as of April 19, 1988, to about $13.9 billion as of September 30, 1990. First City banks' loan portfolios included high-risk loans, such as loans to finance highly leveraged transactions, international loans, and out-of-territory lending. During this period, First City reported $183 million in profits and paid $122 million in cash dividends. In part, the earnings used to justify the cash dividends were profits that depended on income from nontraditional and onetime sources, such as the sale of its credit card operations.

Lending Practices Caused Losses

By September 1990, problems with the quality of its loan portfolios not only caused operating losses but also started to erode First City's capital.

[2]The Collecting Bank was a nationally chartered bank with the sole purpose of liquidating the nearly $2 billion in troubled assets it received from the First City banks as part of the 1988 recapitalization. The Collecting Bank did not accept insured deposits and, as a general rule, did not extend credit.

[3]As a means of both providing the holding company with operating capital and participating in any appreciation of the stock value, FDIC also provided First City Bancorporation with an additional $43 million in exchange for the holding company's junior preferred stock and common stock warrants. In August 1989, FDIC sold the stock and warrants for $43.8 million.

A 1990 OCC examination report strongly criticized the lending practices of First City's lead bank,[4] First City-Houston. Some of its loan losses resulted from continued deterioration in loans made before April 1988. However, other losses were attributed to new loans associated with an aggressive risk-taking posture by new management combined with poor underwriting practices. During and immediately after OCC's 1990 examination, First City made changes in the lead bank's senior executive management, and OCC entered into formal supervisory agreements with First City's Houston, Austin, and San Antonio banks.[5] The agreements required each of the banks to achieve and maintain adequate levels of capital. They also required improvements in (1) underwriting standards, (2) bank management and board oversight, (3) strategic planning, (4) budgeting, (5) capital and dividend policies, (6) management of troubled assets, (7) internal loan review, (8) allowance for loan and lease losses (ALLL), (9) lending activities, and (10) loan administration and appraisals.

According to OCC, First City bank management complied with substantially all of the provisions of the formal agreements, except the capital maintenance provisions. While First City significantly strengthened its underwriting criteria, reduced its aggressive high-risk lending practices, and initiated actions to recapitalize, these efforts did not prevent the First City banks from failing. Between September 30, 1990, and October 30, 1992, problems in the loan portfolios continued to mount. First City bank assets decreased from about $13.9 billion to about $8 billion, and First City incurred total losses of about $625 million. Most of the post-recapitalization losses were from loans at First City's lead bank in Houston and its second-largest bank in Dallas. Among the primary reasons for the banks' financial difficulties were the continued decline in the Texas economy, weaker-than-anticipated loan portfolios in the recapitalized banks, questionable lending activity by First City management within the first 2 years of the recapitalization, and high bank operating expenses.

OCC, as primary federal bank regulator for the lead bank, projected in early 1991 that operating losses would deplete the capital of this bank by year-end 1992. Later, on the basis of First City's operating results, OCC projected that by the end of 1992 bank losses would either (1) deplete the capital at the Houston bank and cause its insolvency or (2) erode the bank's capital to less than 2 percent of its assets, in which case OCC had the

[4]The lending strategy of a lead bank—which is generally the largest subsidiary bank—often reflects that of the whole banking organization.

[5]The management changes included First City's voluntary removal of, among others, a lead bank senior official who was later indicted and convicted of charges stemming from loans he authorized to parties with whom he had affiliations.

authority to close the bank effective December 19, 1992, in accordance with the prompt corrective action provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).[6] The Federal Reserve System (FRS)—the primary federal bank regulator for the Dallas bank—also projected its likely insolvency by the end of 1992. Under the cross-guarantee provisions of the Financial Institution Reform, Recovery and Enforcement Act of 1989 (FIRREA),[7] FDIC could require the 18 otherwise solvent First City banks to reimburse FDIC for any anticipated losses resulting from the failures of the Houston and Dallas banks. FDIC staff advised the FDIC Board that the capital of the 18 banks would not be sufficient to cover the projected losses from the 2 insolvent banks, and the application of the cross-guarantee provision could result in the insolvency of all 20 First City banks.

Regulators Began Contingency Planning for Closure While First City Initiated Further Recapitalization Proposals

OCC, FDIC, and the Texas Banking Commissioner closely monitored the First City banks following the recapitalization, and along with FRS, shared information concerning the Houston and Dallas banks' deteriorating financial conditions. Following its September 1991 and January 1992 examinations of First City-Houston, OCC advised First City that its future viability could not be ensured without a significant capital infusion. Similarly, FRS examination of the holding company in 1991 found that First City lacked adequate capital to support its network of subsidiary banks. Beginning in June 1991, representatives of OCC began working with their counterparts at FDIC on a plan for early intervention and resolution of First City-Houston. These efforts were intense and ongoing throughout 1991 and into 1992.

During 1991 and 1992, First City, OCC, and FDIC considered a number of alternative resolution plans. The resolution plans considered by First City involved three types of transactions:

(1) Type A—Acquisition of First City banks by a stronger, well-capitalized banking company.

(2) Type B—Major capital infusion by an outside investor or investor groups.

[6]Among other provisions, FDICIA gave regulators the authority to take prompt corrective action and declare banks insolvent that are critically undercapitalized (i.e., those with less than 2 percent capital) to reduce costs to the applicable insurance fund.

[7]As part of FIRREA, Congress authorized FDIC to assess anticipated losses associated with a bank failure against commonly controlled depository institutions.

(3) Type C—A self-rescue by the banking organization through some combination of consolidation or sale of subsidiary banks, new capital, and FDIC concessions and financial support.

Initially, First City favored a Type B transaction and indentified a number of potential investors as possible sources of significant new capital. However, in anticipation that raising new capital would be extremely difficult given the banking organization's precarious financial position and continuing OCC concerns with bank management, First City did not actively pursue a Type B transaction. Thereafter, it pursued a Type A transaction almost exclusively.

In October 1991, OCC, FDIC, and First City developed a proposal (Type A transaction) that called for the banks' acquisition by a stronger institution, with the possible need for FDIC financial assistance. In late 1991, FDIC's Division of Resolutions (DOR) staff contacted a number of banking organizations to assess their interest in acquiring the First City banks. While a number of institutions expressed considerable interest in the First City banks and conducted in-depth reviews of bank operations, only one institution ultimately submitted a bid. DOR staff recommended that the bid be rejected for a number of reasons, including its estimated $240 million cost to FDIC, which was higher than FDIC's estimate of $179 million to liquidate the banks at that time. DOR staff also asserted that the proposal was not in the best interest of FDIC because it contained several items that were difficult to quantify and would require costly negotiations with the acquirer. DOR staff asserted that these negotiations could significantly delay completion of any open bank assistance until after December 1992, when FDIC projected the banks would become insolvent.

After the Type A transaction for open bank assistance was rejected by FDIC, First City developed two new self-rescue proposals (Type C) to recapitalize the troubled banks. In July 1992, First City submitted its first self-rescue plan, which called for the closure and immediate reopening of four of the largest First City banks under the control of an acquiring bank. Under this proposal, the acquiring bank would purchase about $7.5 billion of First City banks' performing and fixed assets, and FDIC would enter into a loss-sharing agreement with the acquiring bank for the remaining $1.2 billion of troubled assets.[8] DOR staff recommended this alternative be pursued because they estimated no losses to BIF. According to the staff's projections, a combination of the financial commitments made by the

[8]Under a loss-sharing agreement, the acquirer assumes specified assets and disposes of them with FDIC sharing in any losses (or gains) under stipulated terms and conditions.

acquiring bank and the ALLL previously established by First City banks could absorb additional deterioration that might occur in the quality of the loan portfolios. However, the FDIC Board was concerned about the ability of First City bank management to execute the proposal. In August 1992, the FDIC Board rejected the proposal mainly because of a condition in the plan that required FDIC to guarantee payment in full for all deposits, including uninsured deposits.

In August 1992, First City management submitted another self-rescue proposal to OCC to recapitalize the banks. This proposal called for First City to merge its four largest banks—Houston, Dallas, Austin, and San Antonio. This plan also called for 13 of the remaining 16 First City banks to be sold for an estimated $200 million. An additional $100 million in new equity capital would be raised through a stock offering to new investors and current shareholders. Approximately $96 million would be raised through cost savings from proposed renegotiation of long-term leases. Finally, the proposal would have required FDIC to make concessions totaling over $100 million—stemming largely from the 1988 open bank assistance. The plan projected that the reconstituted and recapitalized First City banks would work their way back to profitability. According to First City documents, it had received commitments from potential investors and landlords needed to raise more than $300 million in capital.

OCC's analysis of First City's August self-rescue proposal concluded that the plan lacked viability due to an estimated $200 million capital shortfall at the reconstituted banks. OCC concluded that the plan did not provide sufficient incoming capital to cover asset quality problems and to provide the capital base required to reestablish the banks for long-term viability. OCC documents also showed that the planned lease renegotiations would not result in the projected savings. Finally, OCC also believed that First City would not be able to raise sufficient capital through stock issuances.

OCC's Accelerated Scheduled Examination in Turn Accelerated the Second FDIC Resolution

Shortly after receipt of First City's August 1992 self-rescue plan, OCC determined that an up-to-date examination was necessary to evaluate the likelihood that the plan would result in long-term viability for First City. The examination of the Houston bank, which began in late August 1992, focused on problem loans. OCC noted significant deterioration in several large loans since its last examination. On the basis of the results of its August examination, OCC determined that the bank had underestimated its ALLL by about $67 million. This amount exceeded the Houston bank's existing equity capital of about $28 million, thus making the Houston bank insolvent and requiring OCC to close it.

The Examiner-In-Charge (EIC) and other OCC officials told us that their adjustment of ALLL was based on both objective and subjective considerations. They said they gave consideration to First City-Houston's history relating to its management's inadequate recognition of loan quality problems and provision for ALLL. The OCC officials said they were also concerned about deteriorating financial conditions at the bank as reflected in dangerous classification trends within its loan portfolio, whereby a higher percentage of loans were recognized as troubled loans and the bank had not experienced the same recovery pattern as experienced by most banks. Further, OCC officials said they were concerned about the bank's financial condition relative to other comparable institutions. In comparing First City's ALLL to that of peer institutions, OCC said that it found that First City had maintained an ALLL level far below that of its peers. OCC said that given First City's asset problems, it believed that First City's ALLL should have been far higher than the peer average. OCC officials said they were also concerned about the weakening economic conditions in Texas and First City's ability to overcome its problems in this environment. Finally, OCC officials said that, by this time, they had lost confidence in First City's management and its processes for establishing proper reserve levels.

On October 16, 1992, OCC advised FDIC of its latest examination findings and its plans to close First City-Houston as soon as practicable so that FDIC could resolve it in an orderly manner. FDIC advised OCC that FDIC could accelerate its projected December 1992 resolution to October 30, 1992, in light of the OCC examination findings. Accordingly, on October 30, 1992, OCC declared the First City-Houston bank insolvent and appointed FDIC receiver. On that same day, the Texas Banking Commissioner closed First City-Dallas on the grounds of imminent insolvency, and FDIC exercised its statutory authority to issue immediately payable cross-guarantee demands on the remaining 18 First City banks. This resulted in the closure of the entire First City banking organization on October 30, 1992.

The Second Resolution: First City Banks Were "Bridged" in 1992 and Sold in 1993

After being advised of OCC's examination findings, FDIC considered two basic alternatives to provide for the orderly resolution of the First City banks: (1) liquidate them immediately or (2) place them under FDIC control and operate them as bridge banks until a sale could be arranged. FDIC chose the latter alternative, which would provide time for FDIC to compare the cost of liquidation to the cost of selling the banks based on bids it planned to solicit after the banks failed. FDIC assumed potential acquirers would be interested in purchasing the banks only if FDIC removed certain risks associated with asset quality problems, potential litigation liabilities, and costly contractual obligations.

The January 1993 sale attracted bids from 30 potential acquirers and resulted in the sale of all 20 of the bridge banks. At the time of sale, FDIC estimated the sale would result in a gain, or surplus, of about $60 million—substantially different from the $500 million loss that FDIC had estimated 3 months earlier. FDIC officials said they were astonished by the proceeds. After resolution and liquidation expenses are paid, FDIC is to return any surplus to First City creditors and shareholders.

First City Filed Lawsuits on Behalf of Shareholders

Shortly after the First City banks were closed, the holding company filed lawsuits on behalf of the shareholders. The lawsuits asserted, among other things, that federal and state banking regulators acted without regard to due process and illegally and unnecessarily closed a solvent banking organization. More specifically, the lawsuits allege that OCC wrongfully closed the lead national bank and that the Texas Banking Commissioner wrongfully closed First City-Dallas.

The lawsuits also asserted that FDIC, as the insurer, was responsible for the inappropriate closure of the financially sound First City banks. According to the suit, FDIC used its cross-guarantee authorities to execute the agency's preconceived plan to gain control of the First City banking organization. The holding company asserted that FDIC's use of its cross-guarantee provisions was both inappropriate and unnecessary, and violated the Fifth Amendment of the Constitution. The suit also noted that on numerous occasions during the summer of 1992, First City Bancorporation offered to merge all the First City banks and restore the capital at the troubled banks. The holding company asserted that if the regulators had approved such an action, their plans to close the First City banks could not have been carried out.

FDIC Considered First City's 1988 Open Bank Assistance the Best Resolution Alternative Available

In 1988, FDIC could have waited until the First City banks were insolvent and either liquidated them or sold them to interested potential acquirers. However, FDIC determined that providing $970 million in assistance to the First City banks was the best alternative available. When FDIC approved First City's open bank assistance, FDIC's resolution alternatives were limited by both regulatory requirements and economic conditions. In April 1988, OCC could not have closed First City banks for insolvency because, at that time, OCC could close a bank for insolvency only when a bank's primary capital was negative. At the time, a bank's primary capital was defined by OCC as the sum of the bank's retained earnings and the bank's ALLL. Although First City had negative retained earnings of $625 million, it also had $730 million in ALLL; hence, it had positive primary capital of $105 million.

Additionally, in the mid-1980s, the Texas banking industry was experiencing its worst economic performance since the Great Depression, which limited FDIC's resolution alternatives. According to FDIC, the economic conditions increased the cost to liquidate troubled banks and reduced the number of potential acquirers. Consequently, FDIC considered two resolution alternatives in August 1987. One was to allow First City losses to continue to mount until the banks' primary capital was depleted, then either liquidate or operate First City banks as bridge banks until potential acquirers could be found. Under the other alternative, FDIC could have provided open bank assistance to willing acquirers of the First City banks—as long as the estimated cost of assistance was less than the estimated cost of liquidation to the insurance fund.

FDIC decided against the first alternative for three reasons. First, FDIC believed that allowing First City banks to continue to deteriorate could jeopardize the stability of the regional banking industry. FDIC also was unsure about operating First City as a bridge bank because bridge banks were new to FDIC (the agency had received bridge bank authority in August 1987). Second, the First City banks were far too large and complex to be the agency's first bridge banks, in FDIC's opinion. And third, FDIC rejected liquidation because estimated liquidation costs were determined to be higher than the estimated cost to the fund for open bank assistance.

FDIC approved $970 million of open bank assistance as the best resolution alternative available. A total of eight parties expressed interest in acquiring the troubled banks, and three submitted bids. FDIC's estimates of potential insurance fund commitments based on those bids ranged from the $970 million for open bank assistance to $1.8 billion for the bid most costly to the insurance fund. According to FDIC records, one of the bids led to estimated fund costs as low as $603 million, but FDIC found that the bidder had used overly optimistic assumptions in the offer. When adjusted, the insurance fund cost of that bid was nearly $1.3 billion.

The Federal Reserve Board (FRB) approved the change of control of these recapitalized banks to the new First City bank management with reservations. FRB's memo approving the change of control warned the new management that assumptions agreed upon by FDIC and First City and used to forecast the banks' road to recovery were optimistic. It also warned that if regional economic conditions did not drastically improve, the recapitalization effort was not likely to succeed.

We reviewed the First City banks' performance following the recapitalization to identify the factors that contributed to the October 1992 failures. We found that the failures resulted from a combination of factors, including the payment of dividends to shareholders, deteriorating loan portfolios, and relatively high operating costs. These findings are described in appendix III.

FDIC Determined That 1992 Bridge Bank Resolution Was Least Costly and Most Orderly

On October 28, 1992, the FDIC Board determined that placing the failed First City banks into interim bridge banks constituted the least costly and most orderly resolution to First City's financial difficulties. On that date the FDIC Board considered three alternatives. Two involved bridge bank resolutions and the third called for a liquidation of First City banks' assets. The difference between the two bridge bank alternatives was that one alternative contained a loss-sharing agreement on a selected pool of troubled assets. Under this agreement, the acquirer would manage and dispose of the asset pool, and FDIC would reimburse the acquirer for a portion of the losses incurred when selling those assets. The other bridge bank alternative did not provide for loss sharing.

The purpose of the two bridge bank alternatives was to provide for an orderly resolution by continuing the business of the banks until acceptable acquirers could be found. FDIC's belief was that the bridge banks would preserve the First City banks' value as going concerns while FDIC marketed them. FDIC estimated that a bridge bank resolution would minimize BIF's[9] financial exposure. FDIC was aware of various parties' interest in acquiring the banks. However, FDIC believed that the potential acquirers would be interested in the banks only after they were placed in receivership, since, after closure, new bank management could renegotiate contractual and deposit arrangements with bank servicers and customers.

FDIC staff estimated resolution costs to BIF ranging from a low of about $700 million (bridge bank with loss sharing) to a high of over $1 billion (FDIC liquidation). FDIC estimated both bridge bank alternatives to be less

[9]With the passage of FIRREA, FDIC continued its responsibility for the insurance fund for banks, which was renamed the Bank Insurance Fund (BIF).

costly than a liquidation primarily because of the likelihood that FDIC would be able to obtain a premium, or a cash payment, from potential acquirers who would be assuming the deposits of the bridge banks. In a liquidation, no such premium would be paid because FDIC pays the depositors directly instead of selling the right to assume the deposits to an acquirer. FDIC also estimated that it could minimize the losses to the insurance fund if it provided loss sharing.

FDIC Lacked Confidence in Initial Loss Estimates

While the FDIC Board believed that a bridge bank with a loss-sharing arrangement was the most orderly and least costly alternative presented by DOR, the ultimate cost of resolving the First City banks was uncertain. DOR staff's initial cost model, which was based on the estimated proceeds and costs of each resolution alternative, estimated that a bridge bank resolution with loss sharing would cost about $700 million. This estimate was based largely on an asset valuation review performed for DOR by an outside contractor.[10]

Representatives from FDIC's Division of Liquidations (DOL), which was responsible for disposing of assets assumed by FDIC, said that liquidating the First City banks would likely cost more than $1 billion. Other FDIC officials—including senior level DOR officials—said that because of the considerable market interest in the banks on a closed-bank basis, the cost to resolve First City banks would likely be about $300 million. The Board determined that placing First City banks into interim bridge banks would cost the insurance fund about $500 million.

The then DOR Director told us that the fact that the Board did not rely solely on the initial DOR cost model was not a deviation from the normal resolution process. He explained to us that the resolution process is dynamic and takes into account FDIC Board deliberations. He noted that it was his responsibility to advise the Board regarding the merits and shortfalls associated with the DOR asset valuation process. He pointed out that DOR's asset valuations estimated the net realizable value for failed bank assets disposed of by FDIC through a liquidation. The methodology determining net realizable value of assets may not always reflect the market value of assets disposed of through such resolution alternatives as an interim bridge bank. Typically, a going concern (including a bridge bank) establishes asset values that attempt to maximize the return to the investor regardless of the period the assets may be held. Net realizable

[10]For more detailed information on FDIC's process for estimating the cost of available resolution alternatives, see our related report entitled 1992 Bank Resolutions: FDIC Chose Methods Determined Least Costly, but Needs to Improve Process (GAO/GGD-94-107), dated May 10, 1994.

asset valuation in a liquidation, on the other hand, attempts to maximize the return to the investor given a limited holding period, often less than 2 years.

According to FDIC documents used in its Board's deliberations, the October 1992 decision to place the First City banks in bridge banks and commit about $500 million to resolve First City was the least costly of the three alternatives the FDIC Board formally considered when the banks were closed. During the year preceding the failure, FDIC and OCC considered and rejected a number of alternatives to resolve the First City banks because the alternatives were considered too costly, did not ensure the banks' long-term viability, or included provisions that were unacceptable from a policy perspective. As previously discussed, OCC had projected that operating losses, caused by imbedded loan portfolio problems, would render First City banks insolvent by December 1992. However, OCC's determination that the Houston bank was insolvent in October 1992 accelerated First City banks' closure by about 2 months. FDIC officials believed the earlier than projected closure unintentionally but effectively precluded either previous or new potential acquirers from doing due diligence, i.e., determining the value of the bank assets, deposits, and other liabilities necessary to ascertain their interest in bidding on the First City banks at the time of closure.

With the Sale of All 20 Bridge Banks, FDIC Projected No Additional Costs to BIF as a Result of the First City Banks' Closure

Although FDIC initially estimated the cost to BIF of the October 1992 resolution of First City banks to be $500 million, the agency has since projected that this resolution will result in no cost to BIF. When it announced the sale of the First City banks in January 1993, FDIC estimated the proceeds generated from the sale would amount to a surplus of about $60 million. In June 1994, FDIC estimated that the surplus may exceed $200 million. As mentioned earlier, any surplus remaining after payment of FDIC's resolution expenses is to be returned to First City's creditors and shareholders.

According to FDIC's analysis of the resolution, sales proceeds were higher than FDIC expected largely because acquirers paid a 17-percent premium for the banks—substantially more than the 1-percent premium on deposits that FDIC had estimated in arriving at the $500 million loss estimate. According to FDIC officials, a deposit premium of 1 percent was typical for failed bank resolutions contemporaneous with the 1992 First City bank resolution. Some FDIC officials, however, told us that at least part of the premium paid by the acquirers should be attributed to the value the acquirers placed on First City bank assets. Since acquirers do not specify in their bids how much they are willing to pay for assets or deposits, neither we nor FDIC can determine the exact basis for the premium.

FDIC Does Not Expect Lawsuits Will Result in Costs to BIF

As of June 1994, FDIC projected that settlement of the lawsuits by First City Bancorporation would result in no cost to BIF. FDIC's projection was based on the assumption that the estimated surplus from the bridge bank sale will exceed its costs to resolve and liquidate the bridge banks, with any excess ultimately to be paid to the holding company. On June 22, 1994, FDIC and the holding company signed a settlement agreement under which First City would immediately receive in excess of $200 million. The settlement would allow the First City Bancorporation to pay its creditors and permit a distribution to its shareholders sooner rather than later.[11] Basic tenets of this proposed settlement are (1) BIF will incur no loss in connection with the 1992 resolution of the First City banks and (2) FDIC will not receive more than its out-of-pocket costs to resolve the banks. Consistent with these tenets, the proposed settlement provides for FDIC to receive the net present value of over $100 million, largely based on First City's guarantee to pay in 1998 toward the retirement of the collecting-bank-preferred-stock FDIC received in return for the 1988 open bank assistance. Any settlement between the two parties cannot be consummated until it is approved by the bankruptcy court. FDIC officials anticipate a decision on the settlement in early 1995.[12]

Lessons to Be Learned From the First City Experience

Generally, the processes used in providing financial assistance, closing banks, and resolving troubled banks should always include adequate safeguards for BIF. The events surrounding the First City resolutions offer valuable lessons for FDIC as the insurer and for all of the primary bank regulators. These lessons relate to how to better assist, close, or otherwise resolve troubled institutions in the future.

Lessons on Open Bank Assistance

Consultation between regulatory agencies might have led FDIC to adopt more realistic assumptions concerning the likelihood of

[11]Failed bank shareholders cannot receive any payments until creditors, including FDIC, have been paid from assets sales and dispositions—a process generally expected to take several years.

[12]FDIC sold its only equity interest in the First City holding company and subsidiary banks in August 1989, and FDIC considers the remainder of the collecting bank preferred stock it holds to be worthless. Consequently, FDIC does not anticipate receiving any proceeds from the settlement that may ultimately be shared by First City holding company stockholders.

success of the $970 million open bank assistance provided First City in 1988.

When FDIC and the new First City management forecasted the First City banks' success in 1988, a key economic assumption was that the economies of Texas and the Southwest would reverse their recessionary trend and grow at about 3 percent per year to mirror the growth rate of the national economy during the mid-1980s. However, the Texas economy grew only an average of 2.2 percent per year between 1989 and 1991. Furthermore, by the late 1980s and early 1990s, the national economy, which had been growing at about 3 percent per year, started to weaken and experience its own recessionary conditions. While approving the change of control to the new First City bank management, FRB raised a concern about these economic assumptions being too optimistic and, if not realized, possibly jeopardizing the success of the recapitalized banks. If FDIC had consulted with its regulatory counterparts in FRS and OCC on economic and financial assumptions for the economy and market in which the assisted bank would operate, it would have had a broader base for, and greater confidence in, the economic assumptions used as a basis to approve the open bank assistance. Such consultation might have produced more realistic assumptions and a better understanding of the likelihood that the financial assistance that FDIC provided could be successful.

The financial assistance agreement could have included safeguards to better ensure that First City undertook only those operations that were within its capabilities and capacities.

At the time of the open bank assistance, the new management of the First City bank projected relatively modest growth, primarily in traditional consumer lending activities. However, under pressure to generate a return for its investors through earnings and dividends, the management pursued much riskier lending and investment activities than it had described in its reorganization prospectus. In addition to taking more risks, the new bank management did not have the expertise, policies, or procedures in place to adequately control these activities. Further, the new bank management entered into contractual arrangements based on projected growth that, when not realized, resulted in higher operating expenses than the bank could sustain. FDIC's assistance agreement did not include sufficient safeguards to ensure that the new bank management actually pursued a business strategy comparable to the one agreed upon as being prudent, or that the bank's activities were in line with management's capabilities or the bank's capacities. In retrospect, such safeguards could have been specified in the agreement.

For example, according to the reorganization prospectus, First City projected that it would expand its overall loan portfolio an average of about 10 percent per year for the first 3 years after the recapitalization. The new bank management projected that consumer, credit card, and energy loans would grow at significantly higher rates than the overall loan portfolio. Management also projected little growth in the riskier areas of real estate and international lending. Contrary to those projections, overall lending activity grew by only about 3 percent in 1989 and actually declined by about 3 percent in 1990 and by over 31 percent in 1991. First City sold its credit card portfolio in early 1990. In addition, First City's actual real estate and international loans accounted for far greater percentages of its total loan portfolio than projected in the 1988 prospectus.

FDIC's financial assistance agreement with First City did not contain provisions requiring First City's management to develop specific business strategies reflecting safe and sound banking practices and internal control mechanisms safeguarding FDIC's investment in the First City banks. Shortly after the recapitalization, OCC examiners criticized the management of First City's Houston bank for not having established policies and procedures to manage the risk associated with the bank's highly leveraged transaction loans. Consequently, OCC directed the bank to establish policies and procedures to minimize the risks of those transactions. OCC similarly directed the bank management to establish policies and procedures related to the Houston bank's international lending activities.

In the meantime, First City bank management paid dividends based on income derived from its lending activity as well as from extraordinary events, such as the sale of its credit card operations. While such payments were permissible under the law at the time, they did not help the bank retain needed capital. Consequently, First City banks lacked sufficient capital to absorb the losses stemming from their lending activities.

Further, First City-Houston entered into long-term contractual arrangements for buildings and services, such as data processing, that were based on overly optimistic projections of future growth. When that growth was not realized, the overhead costs related to these arrangements proved to be a drain on earnings and contributed to the bank's failure.

FDIC would have been in a better position to avoid the risks associated with these banking practices if it had strengthened the open assistance agreement by including provisions to (1) require bank management to develop business strategies relative to its market, expertise, and operational capabilities; and (2) control the flow of funds out of the bank through dividends, contractual arrangements, and other activities, such as management fees paid to the holding company or affiliates. The provisions could have been structured so that the primary regulator held bank management accountable for compliance with them. Such a structure could have involved having bank management stipulate that it would comply with specific assistance agreement provisions. Such a stipulation would have allowed the primary regulator to monitor the bank's adherence to the key provisions of the assistance agreement, including the development of specific business strategies and lending policies and procedures. The primary regulator would then have had the information and authority necessary to take the appropriate enforcement action to ensure compliance with the key provisions of the agreement.

Banks are required to follow statutory limitations on dividend payments provided in 12 U.S.C. §§ 56 and 60. While the regulations implementing the statutes and governing the payment of dividends have been tightened since 1988, banks are still authorized to pay dividends, as long as they satisfy the FDICIA minimum capital requirements.[13] FDIC could have better controlled the flow of funds from the assisted banks by either limiting dividend payments or requiring regulatory approval based on the source of dividends. Such controls are typically used by FDIC and other regulators in enforcement actions when they have reason to be concerned about the safety and soundness of a bank's practices or condition, and they could have been used in a similar manner in the First City assistance agreement.

Lesson on Closure Determinations

OCC could have better documented the bases for its closure decision had its examination reports and workpapers been clear, complete, and self-explanatory.

Congress authorized the Comptroller of the Currency, as the charterer of national banks, to close a national bank whenever one or more statutorily prescribed grounds are found to exist, including insolvency. It is generally agreed in the regulatory community that closure decisions should be supported by clear, well-documented evidence of the grounds for closure.

[13]FDICIA imposes restrictions on capital distributions consisting of cash or other property if such a distribution would result in the institution becoming undercapitalized—meaning one or more minimum levels are not met for any relevant capital measure.

Thus, OCC and other primary regulators' bank examination reports and underlying workpapers supporting closure decisions need to be complete, current, and accurate and provide documentation of the bases for closure decisions that is self-explanatory. However, we were unable to determine the basis for the OCC examiners' finding that First City-Houston's ALLL was insufficient solely from our review of the examination report or workpapers. Specifically, the examination report that OCC conveyed to Houston bank management did not fully articulate the basis for OCC's finding that the bank's ALLL was inadequate. From our review of OCC's workpapers, we were unable to reconstruct the analysis performed to arrive at the need to increase the Houston bank's ALLL. We had to supplement the information in the working papers with additional information obtained through discussions with the EIC and senior level OCC officials in order to determine how OCC arrived at its decision to require First City-Houston to increase its ALLL by $67 million. OCC officials were able to provide additional clarifying information on the basis for this finding. Although some information regarding these concerns was included in the examination workpapers, it was not sufficient for us to independently follow how OCC's examiners arrived at the basis for their conclusion that First City-Houston's ALLL was insufficient.

Thoroughly documented workpapers would also have provided OCC and FDIC with a clear trail of the examiners' methodology, analytical bases of evidentiary support, and mathematical calculations. This would have precluded the need for resource expenditures to reconstruct or verify the basis for examiners' conclusions. Workpapers are important as support for the information and conclusions contained in the related report of examination. As described in OCC's examination guidance, the primary purposes of the workpapers include (1) organizing the material assembled during an examination to facilitate review and future reference, (2) documenting the results of testing and formalizing the examiner's conclusions, and (3) substantiating the assertions of fact or opinions contained in the report of examination. When examination reports and workpapers are clear and concise, independent reviewers, including those affected by the results, should be able to understand the basis for the conclusions reached by the examiner.

OCC officials agreed that the First City examination workpapers should have included a comprehensive summary of the factors considered in reaching the final examination conclusions, especially regarding such a critical issue as a determination of bank insolvency.

Lesson on Resolution Determinations

FDIC's DOR could have considered information from the primary regulator relative to asset quality in making its resolution decisions.

In situations like First City, where the primary regulator had just extensively reviewed a high proportion of the loan portfolio as part of a comprehensive examination and found deficiencies in the bank's loan classification and reserving processes, FDIC resolutions officials should have been able to utilize the examination findings, at least as a secondary source, to test their asset valuation assumptions. This would have been particularly useful because the failure came on short notice and some FDIC officials had reservations about some of the underlying assumptions.

OCC examination officials were apparently communicating with their FDIC examination counterparts about the accelerated First City-Houston bank examination. Even so, FDIC's DOR officials could have benefitted from earlier information on OCC's preliminary findings that indicated that First City-Houston would be insolvent before December 1992, as had been anticipated by all affected parties. This information would have provided DOR more lead time to consider a wider range of resolution alternatives, including soliciting bids from parties it knew to be interested in acquiring the banks. FDIC officials, however, did not believe the interested parties would submit bids since neither they nor FDIC had an opportunity to perform due diligence on the First City bank assets on such short notice.

DOR officials could have used the OCC examiners' assessment of asset quality as a means of verifying the asset valuations estimated through its own techniques. This would have been similar to the way FDIC uses its research model on smaller resolutions, i.e., as an independent check against the valuations. Also, the FDIC Board could have used such information since it was not confident that the more traditional resolution estimating techniques provided reliable results for the circumstances relative to the failing bank. The going concern valuation used by OCC examiners may even have been more relevant than the net realizable valuation used by DOR because FDIC expected a bridge bank or open bank assistance resolution to be the most orderly and least costly resolution alternative.

Agency Comments and Our Evaluation

FDIC and OCC provided written comments on a draft of this report, which are described below and reprinted in appendixes IV and V. FRS also reviewed a draft, generally agreed with the information as presented, but provided no written comments.

FDIC described the report as being well researched and an overall accurate recording of the events that led up to and through the 1988 and 1992 transactions. FDIC offered further information and explanation related to the two transactions, including reasons why some of the lessons to be learned could not have been used by FDIC in 1988 and 1992 or would not have altered the outcomes of these transactions. FDIC further stated, however, that it will consider the lessons enumerated in the report and, where appropriate, incorporate them into future resolution decisions.

We believe FDIC's elaborations about the 1988 and 1992 transactions provide meaningful insights about its assistance and resolutions processes. The Executive Director, in later discussions about FDIC's written comments, assured us that FDIC is open and receptive to the lessons to be learned, and his elaborations were intended to explain the bases for FDIC's decisions and why other positions were not considered or taken at the time of the transactions.

OCC raised concerns that the report might create an inference that we were questioning OCC's basis to close the First City banks and about our suggestion that OCC needs to improve the quality of its examination reporting and workpaper documentation. OCC believes its basic standards for examiner documentation are appropriate for supervisory oversight and examiner decisionmaking purposes. While OCC believes its basic approach to be sound, including its documentation practices, it will consider our views in reviewing current examination guidance for potential revision to provide clarity, ensure consistency, and reduce burden.

Our study was basically intended to provide an accurate accounting of the events, involving both the banks and regulators, that led to the 1988 and 1992 transactions to resolve First City. In compiling this account, we identified lessons to be learned from the First City experience that could potentially improve the insurer's and regulators' open bank assistance, bank closure, and bank resolution processes. We did not question the bases used by the insurer or regulators in making decisions relative to First City, but instead we looked for opportunities to improve those processes to ensure the insurer's and regulators' interests are adequately protected in making future decisions. The insurer and regulators, including FRS, generally agreed to consider the lessons to be learned from the First City experience to improve their processes.

We will provide copies of this report to the Chairman, Federal Deposit Insurance Corporation; the Comptroller of the Currency; the Chairman of the Federal Reserve Board; and the Acting Director of the Office of Thrift Supervision. We will also provide copies to other interested congressional committees and members, federal agencies, and the public.

This review was done under the direction of Mark J. Gillen, Assistant Director, Financial Institutions and Markets Issues. Other major contributors to this review are listed in appendix VI. If you have any questions about the report, please call me on (202) 512-8678.

Sincerely yours,

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

ALLL	allowance for loan and lease losses
BIF	Bank Insurance Fund
CEBA	Competitive Equality Banking Act of 1987
DOL	Division of Liquidation
DOR	Division of Resolutions
EIC	Examiner-in-charge
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FRB	Federal Reserve Board of Governors
FRS	Federal Reserve Sysyem
SAIF	Saving Association Insurance Fund
OCC	Office of the Comptroller of the Currency

Objectives, Scope, and Methodology

Concerned with FDIC's provision of $970 million financial assistance to First City banks in 1988 and their ultimate failure less than 5 years later, the former Chairman of the Senate Committee on Banking, Housing and Urban Affairs asked us to review the events surrounding First City Bancorporation of Texas' 1988 and 1992 resolutions and to use our review to reflect on FDIC's use of open bank assistance. As agreed with the Committee, we focused our review on First City's largest bank in Houston and its second largest bank in Dallas, because the financial difficulties of these two banks resulted in the insolvency of First City's 18 other banks. Our objectives were to review the events leading up to First City's 1988 open bank assistance and its 1992 bank failures to determine

- why FDIC provided open bank assistance in 1988 rather than close the First City banks;
- why the 1992 resolution estimate differed so much from the estimate resulting from the 1993 sale of the banks;
- whether the First City banks' failures in 1992 are expected to result in additional costs to BIF; and
- whether the First City experience provides lessons relevant to the assistance, closure, and/or resolution of failing banks.

To achieve our objectives, we reviewed examination reports and related available examination documents and workpapers relative to First City's Houston and Dallas banks and other subsidiary banks for 1983 through 1992. We began our review of examination reports with the 1983 examination because OCC officials told us that was when they first identified safety and soundness deficiencies in First City banks. The 1993 examination also precipitated the first supervisory agreement between First City management and the bank regulatory agencies.

In reviewing the examination reports we sought to obtain information on the condition of the banks at the time of each examination and the significance of deficiencies as identified by the regulators. We reviewed examination workpapers, correspondence files, and management reports to gain a broader understanding of the problems identified, the approach and methodology used to assess the conditions of the First City banks, and the regulatory actions taken to promote or compel bank management to address deficient conditions found by regulators. We also used the examination workpapers to compile lists of loans that caused significant losses to the banks to try and compare the loan quality problems arising from loans made before the recapitalization to those made by new bank management.

We interviewed the OCC examiners-in-charge of the 1989 examinations and all subsequent examinations to obtain their perspectives on the conditions found at the First City banks. We also interviewed OCC National Office officials to obtain their views on the adequacy of OCC's oversight of the banks. We reviewed all relevant examination reports, workpapers, and supporting documentation to assess their adequacy in explaining the positions taken by OCC relative to First City-Houston and the Collecting Bank. When we were unable to gain adequate information from the examination records, we sought further explanations from OCC examination officials and assessed those explanations when received. We also reviewed FDIC and FRS records of examinations and supporting documents, particularly those related to First City-Dallas. We also discussed issues relating to First City banks with FDIC and FRS officials.

Further, we reviewed First City Bancorporation financial records and supporting documents and discussed issues relating to OCC, FDIC, and FRS oversight with First City officials.

Finally, we reviewed FDIC records relating to First City's 1988 recapitalization and FDIC's 1992 and 1993 bridge bank decisions. We discussed issues relating to these actions with FDIC, OCC, FRS, and First City officials to obtain their viewpoints on the actions taken. We also reviewed FDIC, OCC, and FRS records assessing the economy and the conditions of Texas financial institutions from the mid-1980s to the early 1990s.

FDIC and OCC provided written comments on a draft of this report. FRS also reviewed a draft, generally agreed with the information as presented, but provided no written comments. The agencies' written comments are presented and evaluated on page 21 of the letter and reprinted in appendixes IV and V. We did our work between January 1993 and June 1994 at FDIC, OCC, and FRS in Washington, D.C.; at FDIC, OCC, and FRS in Dallas; and at the First City banks in Houston and Dallas. We did our work in accordance with generally accepted government auditing standards.

Changes in the Bank Regulatory Structure and Related Authorities Between 1987 and 1993

The 1980s and the early 1990s were tumultuous times for the banking industry, especially in the Southwest. During this time, the banking industry experienced record profits followed by record losses, and a number of legislative and regulatory changes altered both the way banks did business and the way banks were regulated.

The Banking Regulatory Structure

The responsibility for regulating federally insured banks is divided among three federal agencies. OCC is the primary regulator for nationally chartered banks. FRS regulates all bank holding companies and state-chartered banks that are members of FRS. FDIC regulates state-chartered banks that are not members of FRS. FDIC is also the insurer of all federally insured banks and thrifts, which gives it the dual role of being both the regulator and insurer for many banks.

The primary role of federal regulators is to monitor the safety and soundness of the operations of both individual banks and the banking system as a whole. The regulators' major means of monitoring the banks is through the examination process. Examinations are intended to evaluate the overall safety and soundness of a bank's operations, compliance with banking laws and regulations, and the quality of a bank's management and directors. Examinations are also to identify those areas where bank management needs to take corrective actions to strengthen performance. When a regulator identifies an area where the bank needs to improve, it can require the bank to initiate corrective action through either formal or informal measures. These measures can be as informal as a comment in the examination report or as severe as the regulator ordering the bank to cease and desist from a particular activity or actually ordering the closure of the bank.

The role of the insurer is to protect insured depositors in the nation's banks, help maintain confidence in the banking system, and promote safe and sound banking practices. As the insurer of bank deposits, FDIC may provide financial assistance for troubled banks. The assistance may be granted directly to the bank or to a company that controls or will control it. FDIC may also grant assistance to facilitate the merger of banks. When a chartering authority closes a bank, it typically appoints FDIC as receiver for the bank. FDIC then arranges for insured depositors to be paid directly by FDIC or the acquiring bank and liquidates the assets and liabilities not assumed by the acquiring bank.

Many banks, including First City's, are owned or controlled by a bank holding company and have one or more subsidiary banks. Typically, in a bank holding company arrangement, the largest subsidiary bank is referred to as the lead bank. The subsidiary banks may or may not have the same types of banking charters, i.e., either national or state charters. Consequently, different regulators may be responsible for overseeing the lead bank and the other subsidiary banks in the organization, with FRS responsible for overseeing all bank holding companies. First City Bancorporation of Texas typified this structure. It consisted of a holding company, a nationally chartered lead bank, 11 other nationally chartered subsidiary banks, 5 state-chartered banks that were members of FRS, and 3 state-chartered banks that were not members of FRS. Hence, the First City organization was supervised and examined by all three federal bank regulators.

Significant Bank Closure and Resolution Changes

Between the time FDIC first announced open bank assistance for First City in 1987 and its closure in 1992, a number of regulatory and legislative initiatives gave the federal government greater authority to deal with troubled financial institutions. Passage of the Competitive Equality Banking Act of 1987 (CEBA), the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) provided both regulators and the insurer greater authorities in dealing with troubled financial institutions. Their passage also provided the impetus for regulatory changes that granted regulators and the insurer greater authorities to close and resolve troubled financial institutions.

Changes Affecting Bank Closures

The regulators' expanded authority to close a bank is possibly one of the most significant changes that has occurred in the federal government's oversight of banks. At the time of the 1988 First City reorganization, OCC had the authority to appoint FDIC as receiver for a national bank whenever OCC, through its examination of the bank, determined that the bank was insolvent. The National Bank Act did not define insolvency, and the courts afforded OCC considerable discretion in determining the standard for measuring insolvency. OCC used two standards to measure insolvency—a net worth standard and a liquidity standard. Basically, a bank becomes net worth or equity insolvent when its capital has been depleted. Similarly, a bank becomes liquidity insolvent when it does not have sufficient liquid assets—i.e., cash—to meet its obligations as they become due, regardless of its net worth.

Following the 1988 First City reorganization, OCC promulgated a regulation that allowed it to find a national bank insolvent at an earlier stage than before. Under the new rule, OCC redefined primary capital to exclude a bank's allowance for loan and lease losses. Prior to this change, OCC considered a national bank's regulatory capital to include not only its retained earnings and paid-in capital but also the allowance a bank had set up for loan and lease losses; i.e., for uncollectible or partially collectible loans. According to OCC, the change brought OCC's measurement of a bank's equity more closely in line with generally accepted accounting principles' measurement of equity. While this action was not specifically required by FIRREA, OCC stated the change was within the spirit of the 1989 amendments to the federal banking laws.

The cross-guarantee provisions of FIRREA also granted FDIC authority to recoup from commonly controlled depository institutions any losses incurred or reasonably anticipated to be incurred by FDIC due to the failure of a commonly controlled insured depository institution. As in the case of the First City banks, the cross-guarantee assessment may result in the failure of an otherwise healthy affiliated institution if the institution is unable to pay the amount of the assessed liability. This provision imposes a liability on commonly controlled institutions for the losses of their affiliates at the time of failure, thereby reducing BIF losses. The law gives FDIC discretion in determining when to require reimbursement and to exempt any institution from the cross-guarantee provisions if FDIC determines that the exemption is in the best interest of the applicable insurance fund.

Changes Affecting Bank Resolutions

The manner in which FDIC can resolve troubled banks involves another significant set of changes that has occurred since FDIC announced First City's first resolution in 1987. More specifically, FDICIA now requires FDIC to evaluate all possible methods for resolving a troubled bank and resolve it in a manner that results in the least cost to the insurance fund. Prior to FDICIA's least-cost test, FDIC was required to choose a resolution method that was no more costly than the cost of a liquidation. Currently, the only exception to the least-cost determination is when the Secretary of the Treasury determines that such a selection would have a serious adverse effect on the economic conditions of the community or the nation and that a more costly alternative would mitigate the adverse effects. To date, the systemic risk exception has not been used.

Changes to Open Bank Assistance Authority

FDIC's ability to provide open bank assistance has also undergone significant changes since FDIC assisted First City in 1988. At that time, FDIC was authorized to provide assistance to prevent the closure of a federally insured bank. FDIC was permitted to provide the assistance either directly to the troubled bank or to an acquirer of the bank. Before providing the assistance, FDIC had to determine that the amount of assistance was less than the cost of liquidation, or that the continued operation of the bank was essential to provide adequate banking services in the community. To implement these provisions, FDIC adopted guidelines that open assistance had to meet. The key guidelines are summarized below:

- The assistance had to be less costly to FDIC than other available alternatives.
- The assistance agreement had to provide for adequate managerial and capital resources (from both FDIC and non-FDIC sources) to reasonably ensure the bank's future viability.
- The agreement had to provide for the assistance to benefit the bank and FDIC and had to include safeguards to ensure that FDIC's assistance was not used for other purposes.
- The financial effect on the debt and equity holders of the bank, including the impact on management, shareholders, and creditors of the holding company, had to approximate what would have happened if the bank had failed.
- If possible, the agreement had to provide for the repayment of FDIC's assistance.

FDICIA placed additional limits on FDIC's use of open bank assistance. FDICIA added a new precondition to FDIC's authority to provide open assistance under section 13(c), which is summarized below. Under FDICIA, FDIC may consider providing financial assistance to an operating financial institution only if the following criteria can be met:

(a) Grounds for the appointment of a conservator or receiver exist or likely will exist in the future if the institution's capital levels are not increased and it is unlikely that the institution will meet capital standards without assistance.

(b) FDIC determines that the institution's management has been competent and has complied with laws, directives, and orders and did not engage in any insider dealing, speculative practice, or other abusive activity.

In addition to the previously discussed statutory changes, FDICIA contained a resolution by Congress that encourages banking agencies to pursue early resolution strategies provided they are consistent with the new least-cost provisions and contain specific guidelines for such early resolution strategies.

Since FDICIA, a further statutory limitation has been placed on open assistance transactions. Section 11 of the Resolution Trust Corporation Completion Act of 1993 prohibits the use of BIF and Saving Association Insurance Fund (SAIF) funds in any manner that would benefit the shareholders of any failed or failing depository institution.

In FDIC's view, as set forth in its report to Congress on early resolutions of troubled insured depository institutions, this provision "largely eliminates the possibility of open assistance, except where a systemic risk finding" is made pursuant to the least-cost provisions.

Bridge Bank Resolution Authority

Another change to FDIC's resolution alternatives occurred when CEBA provided FDIC the authority to organize a bridge bank in connection with the resolution of one or more insured banks. Essentially, a bridge bank is a nationally chartered bank that assumes the deposits and other liabilities of a failed bank. The bridge bank also purchases the assets of a failed institution and temporarily performs the daily functions of the failed bank until a decision regarding a suitable acquirer or other resolution alternative can be made.

Bank Management Actions That Contributed to the Failure of the 1988 Recapitalization of First City

To better understand some of the factors that contributed to the ultimate failure of the 1988 recapitalized First City banks, we reviewed First City's activities from 1988 to 1990 as reflected in examination reports and workpapers. The results of that review are summarized in this appendix.

First City Relied Too Heavily on Income From Nontraditional Sources

First City Bancorporation banks' reported profits in 1988, 1989, and 1990 depended on nontraditional sources of income that were not sustainable. These profits were then used to justify the payment of cash dividends during 1989 and 1990 that significantly reduced the banks' retained earnings. First City's reliance on income from the Collecting Bank nearly equalled First City's net income during 1988 and 1989, First City's only profitable years.

Furthermore, we found that if it were not for the $73 million in interest and fee income the Collecting Bank paid First City in 1988, the latter would have lost about $7 million that year. While First City's 1989 net income did not completely depend upon the Collecting Bank's interest and fees, we found that such income accounted for nearly $100 million of the $112 million in net income earned by First City during 1989. Another nontraditional source of First City income was generated in the first quarter of 1990 when First City sold its credit card portfolio for a $139 million profit. This sale enabled First City to turn an otherwise $49 million loss from operations into a $90 million net profit during the quarter that ended March 31, 1990.

These nontraditional sources of income accounted for nearly all of First City's net income during the first 2 years of operations after recapitalization and did not necessarily indicate a significant problem with First City's operations. It is also not necessarily a basis for criticizing First City's management. First City's reliance on income from nontraditional sources could be explained as the result of initial start-up problems associated with taking over a large regional multibank holding company during a period of economic instability. What is noteworthy is that First City used the profits on income from nontraditional and onetime sources to pay $122 million in cash dividends, thereby decreasing the bank's retained earnings. The assistance agreement's only limitation on the payment of dividends was that common stock dividends could not exceed 50 percent of the period's earnings.

First City Experienced Unexpected Loan Deterioration

The anticipated success of the recapitalized First City was at least partially based upon the assumption that First City Bancorporation, including the Collecting Bank, would not experience further loan portfolio deterioration. This assumption proved to be incorrect. Problems with both pre- and post-recapitalization loan portfolios resulted in significant loan charge-offs and the depletion of bank equity. For example, we found that about $270 million in assets that originated prior to the recapitalization at First City's Houston and Dallas banks resulted in nearly $75 million in losses. Furthermore, problems with pre-recapitalization assets also plagued the Collecting Bank. These problems forced First City to charge-off nearly $200 million of Collecting Bank notes by the time the banks were closed in October 1992.

First City also experienced significant problems with loans originated after the 1988 reorganization. We found that First City suffered about $300 million in losses on such loans. Some of these losses occurred as a result of First City's aggressive loan growth policy that increased its portfolio of loans to finance inherently risky, highly leveraged transactions. First City's highly leveraged transaction lending peaked in 1989 at more than $700 million. Other significant losses resulted from First City's international and other nonregional lending practices. Still other losses resulted from poor underwriting practices or adverse economic conditions.

First City's High Operating Costs Strained Its Profits

First City's recapitalization prospectus predicted that the banks would realize savings of more than $100 million per year by reducing operating expenses to a level commensurate with industry standards. While First City realized at least some of the anticipated savings during its first 2 years of operations, it was unable to sustain these cost-cutting efforts. According to both OCC and FDIC, high operating expenses contributed to First City's 1992 failure.

As shown in table III.1, First City's operating expenses did not decrease as First City's net income, gross profits, and total assets decreased. Rather, First City's operating expenses were the lowest during 1988 and 1989, when it reported year-end profits, and highest during 1990 and 1991, when it lost more than $380 million. Our review of First City's escalating operating expenses showed that during 1990 and 1991—a period when the banks' revenues and assets were decreasing—its data processing and professional services expenses increased because of the way in which payments for these services were structured in related long-term contracts. Furthermore, First City's operating expenses were already high due to above-market long-term building leases negotiated before the recapitalization.

Table III.1: Comparison of First City's Operating Expenses to Net Income, Total Revenues, and Total Assets, 1988-1991

Dollars in millions

Year ending	Operating expenses	Net income	Total revenues	Total assets
12/31/88	$304	$66	$885	$12,195
12/31/89	450	112	1,458	14,081
12/31/90	590	(158)	1,492	13,344
12/31/91	548	(225)	1,144	9,943

Source: OCC examination reports and workpapers.

Comments From the Federal Deposit Insurance Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FDIC

Federal Deposit Insurance Corporation
Washington, DC 20429

Executive Director
Divisions of Compliance, Resolutions and Supervision

October 24, 1994

Hon. James L. Bothwell
Director, Financial Institutions and Market Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

Re: GAO DRAFT REPORT - Lessons Learned from Resolving First City Bancorporation of Texas

We appreciate the opportunity to have an advance review of subject report and to provide comments. We find the report to be a well researched and an overall accurate recording of the events that led up to and through the 1988 and 1992 transactions. We offer the following comments:

1988 Transaction

See comment 1.

As pointed out in your report, only after the 1988 transaction did the FDIC receive a number of legislative initiatives giving us greater latitude and authority to deal with troubled institutions. While we did receive bridge bank authority prior to the 1988 transaction, we lacked the cross guaranty authority that we subsequently received with FIRREA. Consequently, had the OCC and state authority closed the lead banks in Houston and Dallas, and as receiver, we established a bridge bank, 58 other bank subsidiaries in Texas (55 of which were commonly named - First City) would most likely have suffered liquidity pressures if not all-out deposit runs. Few of the general public at that time distinguished between a branch of First City and a free standing First City subsidiary bank. Had any of the better remaining banks survived fallout liquidity pressures, their value would have enured to the owner, First City Bancorporation, while the losses in the closed First City banks would have been borne by the federal government, the FDIC. That was the exact reason for us later receiving cross guaranty authority, to avoid holding companies from sticking us with their loss banks and retaining banks with value. The open bank transaction, therefore, captured the value of the better bank subsidiaries.

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See comment 2.

Insofar as consultation with other regulatory agencies, all agencies were provided copies of all proposals and were invited to all important meetings between the FDIC and the prospective bidders. The Federal Reserve Board did, as stated in the report, opine that some of the economic decisions in the winning bidder's proposal appeared optimistic and, if not realized, could "possibly" jeopardize the success of the recapitalized banks. The Board of Directors were made aware of all regulators' opinions prior to making their final decision.

See comment 3.

Insofar as the FDIC not including "...provisions requiring First City's management to develop specific business strategies reflecting safe and sound banking practices and internal control mechanisms safeguarding FDIC's investment in the First City banks" and not controlling the banks' dividends, the FDIC made a deliberate and conscious decision not to impose such conditions for two reasons. The 1988 recapitalization effort involved the raising of some $500 million in the capital market; had the FDIC imposed conditions over and above the standard controls and authorities vested in the primary federal regulators, the OCC and the Federal Reserve, the monies most likely could not have been raised. Secondarily, the primary federal regulators have long held that their regulations and supervisory controls are sufficient to protect the FDIC's interest without us overlaying controls of our own. Furthermore, at the time of the transaction, we had no authority to enforce any conditions we may have imposed because we were not the primary federal regulator for the successor bank. We are confident that the OCC and Federal Reserve believe they each have sufficient authority to control dividends, management fees, require strategic plans, etc. without having to have an FDIC assistance agreement requiring same.

See comment 4.

1992 Transaction

Your report discusses several items which the FDIC might have considered in advance of the "bridging" of the First City banks in October 1992.

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See comment 5.

As to the point that earlier knowledge of OCC failure findings would have provided the FDIC with a wider range of alternatives; it is unlikely that the FDIC would have structured this resolution as anything but a bridge bank even if we had been given significant earlier warning by the OCC that the Houston bank of the First City system was insolvent. The FDIC and First City management had been in discussion since October 1991 and various unassisted and open assistance structures were discussed with both First City management and third parties. It would have been very difficult to orchestrate a traditional failure process which allows the FDIC to market the institution while the bank is still open and transfer all the deposits and most of the assets upon failure. Both the size of First City, 20 banks across the state of Texas with approximately $9 billion in assets, as well as the resolve of management to try anything short of a closure would have inhibited the FDIC's ability to deliver a successful resolution. Different than other situations, such as Southeast, where DOR felt that the logical third parties had completed sufficient due diligence to allow for educated bids, DOR strongly believed that both large and small banks needed full and further due diligence for the sale of these banks. As it turned out, 2 1/2 weeks after closure, due diligence began and during the succeeding seven weeks 42 institutions performed due diligence on one or more of the 20 bridge banks. This manner of marketing would have been impossible if these institutions were not under FDIC control. While a scaled down version of marketing these institutions may have been able to be designed, the receiverships and, therefore, the shareholders of First City Bancorporation of Texas would not have received nearly the "astonishing" value paid by the consortium of buyers of the bridge banks.

See comment 6.

As to the suggestion that DOR could have used the OCC examination findings as a means of assessing asset quality and verifying the AVR; DOR's experience shows us that examination reports do not easily permit a comparison of examination results with asset values. Examination results do not yield estimates of value for particular loans/assets but rather they predict expected payments or measure adequacy of collateral. Exams by their nature enable the regulator to determine if a bank is viable, and if not viable DOR is called in to estimate market value. In addition to market value, an AVR predicts the expected cost of the FDIC's liquidation of that asset. This component would be foreign to an examination finding and complicate the comparison.

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We will consider the "Lessons to be Learned" enumerated in the report and, where appropriate, incorporate them into future resolution decisions.

Sincerely,

John W. Stone

John W. Stone
Executive Director,
Divisions of Compliance,
Resolutions, and Supervision

The following are GAO's comments on the Federal Deposit Insurance Corporation's letter dated October 24, 1994.

GAO Comments

1. We agree with FDIC that it received bridge bank authority in 1987, prior to the 1988 First City resolution, but did not receive cross-guarantee authority until later, in 1989. We do not dispute the FDIC scenario regarding what may have happened had it exercised its bridge bank authority on the two troubled First City banks in 1988 without having the authority to recover the losses from the other affiliated First City banks. Under the circumstances, FDIC alternatives for resolving the First City banks in 1988 were to either provide open bank assistance for the two troubled banks, or wait until they failed and consider the other resolution methods, including bridge banks.

2. We do not dispute the FDIC position that regulatory agencies were invited to all important meetings or that its Board of Directors was aware of the regulators' opinions prior to making the 1988 open bank assistance decision. Our suggestion, however, is for FDIC to actively consult with its regulatory counterparts about key assumptions used in resolution alternatives recommended to the Board. We believe FDIC could take better advantage through greater consultation in making economic projections. The Federal Reserve, for example, has developed considerable expertise. In later discussions with the Executive Director, he agreed with us that such consultation with regulatory counterparts would be of value, although he noted that the accountability for the resolution decision, along with its assumptions, resides with FDIC.

3. In later discussions with the Executive Director, he told us that he does not disagree with our suggestion that FDIC include safeguards in open bank assistance agreements. His only concern would be if the safeguards were so stringent as to discourage potential private investors, thereby potentially costing FDIC more to resolve a troubled bank. He agrees with us that FDIC's responsibility is to protect the Bank Insurance Fund and FDIC should include safeguards in its assistance agreements.

4. We agree that FDIC could realistically enforce the assistance agreement conditions only if FDIC determined that the bank breached the contractual conditions. The Executive Director told us that he is receptive to including provisions in future FDIC assistance agreements that authorize primary regulators to take enforcement actions if they find noncompliance with safeguards contained in future FDIC assistance agreements. His primary

concern involves the potential of discouraging private investors, although he also believes there may be some practical problems in agreeing on conditions that serve the interests of the acquirer, the insurer, and the primary regulator. The Executive Director understands that such provisions would enable the primary regulator to gather the necessary information and have the requisite authority to take the appropriate enforcement action to ensure compliance with the relevant provisions of the assistance agreement.

5. We agree that in 1992, earlier FDIC notification of OCC's finding that First City-Houston was insolvent may not have provided FDIC with a broader range of resolution alternatives because First City management was still convinced that it could raise sufficient capital to make the bank financially viable. Consequently, while some potential investors or acquirers had performed due diligence relative to earlier First City self-rescue proposals, FDIC did not believe sufficient due diligence had been performed by potential acquirers or that First City management would permit those interested to perform due diligence. Therefore, FDIC believed bridge banks would provide for the most orderly resolution, which FDIC also determined to be the least costly resolution alternative available at that time. While earlier notification may not have affected the First City resolution, the Executive Director agreed with us that early notification of insolvency is critically important for FDIC to consider the full range of resolution alternatives. He also said that FDIC is in regular contact with primary regulators to ensure early warning of potential insolvencies to maximize its resolution options.

6. We agree that examiners typically value assets on a going concern basis, and resolvers value the assets on a net realizable value presuming that they will be liquidated. The Executive Director, however, agreed with us that in unique situations like First City—where a high percentage of the assets were just assessed by examiners and market interest in the troubled banks suggests the assets will be acquired by a healthy bank—FDIC could use the examiners' assessments as a secondary source to check on the validity of its asset valuation review results. Such a use would be comparable to how FDIC generally uses its research model, the results of which the FDIC Board of Directors may consider in its deliberations in making its resolution decisions.

Comments From the Comptroller of the Currency

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

January 5, 1995

Mr. James L. Bothwell
Director, Financial Institutions and Market Issues
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have reviewed your draft report titled, FAILING BANKS: Lessons Learned From Resolving First City Bancorporation of Texas. The report was prepared to respond to a request from the Chairman of the Senate Banking Committee. Specifically, the Chairman asked why the FDIC provided financial assistance to recapitalize the banking franchise in 1988; why resolution cost estimates to the Bank Insurance Fund (BIF) differed from the time of the failure of the First City banks in 1992 to their sale in 1993; what, if any, additional cost to BIF may result from the second resolution; and what lessons are offered relevant to the assistance, closure and resolution processes. To answer those questions, GAO established an overall review objective: to get a complete understanding of the safety and soundness of the banks' operations, the regulators' examination and enforcement histories, and the bases for the 1988 and 1992 resolution decisions. Your auditors reviewed documentation and conducted interviews. We offer the following suggestions regarding the draft report:

See comment 1.

The language of the report, as drafted, could create the inference that the GAO questions the OCC's basis to close the First City banks. A clear statement in the report is needed to clarify that this is not the GAO's intent nor its conclusion.

See comment 2.

The draft report also suggests that OCC needs to improve the quality of its reporting and workpaper documentation by providing more clarification and detail. While we respect the GAO's views in this regard, we believe the basic standards we use for examiner documentation are appropriate for the supervisory oversight role and decisions made by examiners. They use a combination of three primary sources: the computer-based Supervisory Monitoring System, working papers and reports of examination.

We will give consideration to your concerns as we implement improvements to our processes, including documentation practices. While we believe our basic approach is sound, we are reviewing our guidance to examiners for potential revision in an effort to provide clarity, to assure consistency and to reduce burden. Please be assured that we will continue to do our best to assist you in meeting your audit objectives.

Thank you for the opportunity to comment on the draft report. If you would like to discuss our comments, please contact me at 874-5080.

Sincerely,

Judith A. Walter

Judith A. Walter
Senior Deputy Comptroller for Administration

The following are GAO's comments on the Comptroller of the Currency's letter dated January 5, 1995.

GAO Comments

1. Our objectives in the First City study included a review of the processes used by regulators to assist, close, or otherwise resolve failing financial institutions. We reviewed the adequacy of those processes, including the bases for the related decisions made by federal regulators for First City. While we found some deficiencies in the processes as applied in the First City decisions and suggested opportunities to improve those processes from the First City experience, it was not our objective nor did we take a position on the regulators' decisions.

2. We agree with OCC that its basic standards for examination reporting and workpaper documentation are adequate based on this study and on other GAO studies of OCC's examination process. In our report entitled Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15), dated February 16, 1993, we found that OCC generally adequately documented its examination results. Although we did not find in our study of First City adequate documentation for the examination results, OCC officials assured us that our concerns are being considered in their efforts to improve OCC examination processes, including the documentation of examination results.

Major Contributors to This Report

General Government Division, Washington, D.C.

James R. Black, Senior Evaluator
Ned R. Nazzaro, Evaluator
Desiree Whipple, Reports Analyst
Phoebe A. Jones, Secretary

Dallas Regional Office

Ronald Berteotti, Assistant Regional Manager
Jeanne Barger, Issue Area Manager
John V. Kelly, Evaluator-in-Charge
Steven D. Boyles, Site-Senior
Michael J. Coy, Evaluator

Office of the General Counsel

Rosemary Healy, Senior Attorney

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