

## Fear of Failing

*Bailout: An Insider's Account of Bank Failures and Rescues*, by Irvine H. Sprague.\* New York, N.Y.: Basic Books, 1986. 299 pages. \$17.95.

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Of the fifty largest bank failures in U.S. history, forty-six were handled by the Federal Deposit Insurance Corporation (FDIC) in such a way that no depositor, insured or uninsured, lost a penny. In contrast, thirty of the fifty smallest banks to fail in the last twenty years were liquidated by the FDIC with uninsured depositors left at risk. Irvine H. Sprague, the author of *Bailout: An Insider's Account of Bank Failures and Rescues*,<sup>1</sup> was a member of the Board of Directors of the FDIC when many of the decisions involving large bank failures were made. He has given us a readable chronicle of the years he spent there.

Like many of the FDIC's critics, Sprague claims that he too was offended by this disparity of treatment in which some banks are deemed "too big to let fail."<sup>2</sup> However, his account attempts to make clear why certain banks are so characterized, and what economic and social issues arise whenever a bank bailout is considered.

Sprague is the first FDIC Chairman to write his memoirs. His past experience as a newspaper reporter serves him well. The book reflects Sprague's recognition that readers are more likely to be interested in the actions of the FDIC than in his personal life or philosophy. He does, however, draw on his experience behind the scenes at the FDIC to dramatize the secret negotiations that are the FDIC's business when it renders assistance to its member banks. Despite a rather strained effort to show that he was responsible for all the major decisions of the FDIC during his two terms as a board member—from 1969 through 1972, and from 1979 through 1986—Sprague contributes valuable insight into the FDIC decision-making process. Unfortunately, he leaves unresolved the

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1. I. SPRAGUE, *BAILOUT: AN INSIDER'S ACCOUNT OF BANK FAILURES AND RESCUES* (1986) [hereinafter by page number].

2. P. 259.

tantalizing issues of fairness and economic policy raised by the contrast between the treatment accorded to big and small banks.

### I. Bailouts, Near-Bailouts, and the Big Bailout of Continental Illinois

Sprague has divided his book into five sections. The first<sup>3</sup> sets out the legal and historical context of the three major regulatory bodies involved in supervising banks: the FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency. Rendering assistance to failing banks is, however, within the exclusive jurisdiction of Sprague's former home, the FDIC. Opinions about the extent of this jurisdiction differ, reflecting the tension between the competing policy concerns of depositor protection and market discipline. As Sprague demonstrates, even this difficult choice is complicated when the potential failure of a large bank adds the additional variable of international financial repercussions.

The book's second section<sup>4</sup> describes "the first three bailouts," Unity Bank in Boston,<sup>5</sup> Bank of the Commonwealth in Detroit,<sup>6</sup> and First Pennsylvania Bank in Philadelphia.<sup>7</sup> The third of these Sprague calls "the only certified successful bailout in history."<sup>8</sup> All three included elements of timing, tactics, and politics that would be heightened in the story of Continental Illinois.

The third section<sup>9</sup> discusses "Two Potential Bailouts That Never Happened." The first involved the Penn Square Bank in Oklahoma City.<sup>10</sup> In its wake came the crisis at the Seattle First National Bank (Seafirst),<sup>11</sup> the first major casualty resulting from Penn Square's mismanagement. The FDIC decided not to bail out Penn Square and was spared the need to act on Seafirst by Bank of America's acquisition of the bank. FDIC strategies and policy were further developed in dealing with these two banks in 1982, Sprague notes.

"Then came Continental."<sup>12</sup> The run on the Continental National Bank and Trust Company happened in May 1984. Although Sprague indicates agreement in the abstract with the view that all banks should be equally subject to market discipline, in practice "no one who holds the

3. Pp. 3-32.

4. Pp. 35-106.

5. Pp. 35-52.

6. Pp. 53-76.

7. Pp. 77-106.

8. P. 106.

9. Pp. 109-45.

10. Pp. 109-34.

11. Pp. 135-45.

12. P. 9. Sprague describes the Continental bailout in the fourth part of his book, pp. 149-228.

responsibility could possibly agree,”<sup>13</sup> nor would he gamble with a financial institution of that size and scope.

His book concludes with a fifth section, “Where Do We Go From Here?,”<sup>14</sup> which contains a brief discussion of the lessons he thinks we should learn from his experiences, an abbreviated version of the policy debate that rages around bailouts, and some general prescriptions for enhancing the fairness of the system. Sprague states that the purpose of the book is to chronicle “the evolution of the essentiality doctrine.”<sup>15</sup> Until recently, in order to provide direct assistance to an open bank, the FDIC had to find that the continued existence of a failing bank was “essential to provide adequate banking service in its community.”<sup>16</sup> This is a somewhat unfortunate focus, since such assistance can now be provided without the “essentiality” finding. In fact, the resolution of the failure of Continental Illinois—the focal point of the book—did not require such a finding.

Federal deposit insurance covers deposits up to \$100,000. But the FDIC has various options it can use in handling a bank failure, and these options have differing implications for different claimants. Sprague correctly points out that as members of the FDIC Board of Directors, “[i]t was very much at our discretion whether and when any person with more than \$100,000 in a failed bank would receive any part of it.”<sup>17</sup>

When a bank fails, the most straightforward option for the FDIC is the deposit payoff. Following a declaration of insolvency by the chartering authority, the bank is closed. The FDIC pays off insured depositors and, as receiver, liquidates the bank’s assets. As collections are made on the assets, funds are distributed to uninsured depositors on a pro rata basis, including payments to the FDIC for the amount which it has advanced to insured depositors.

As an alternative to payoff and liquidation, the FDIC can arrange for the failed bank to be acquired by a healthy institution. This type of

13. P. 244.

14. Pp. 231-64.

15. P. ix.

16. Until amended by the Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12 U.S.C.), the only provision in the Federal Deposit Insurance Act, 12 U.S.C. §§ 1811-1832 (1982) for direct assistance to an open bank was Section 13(c), which empowered the Board of Directors of the FDIC to make a loan or provide other assistance to a bank, regardless of cost, provided (1) the bank was in danger of failing and (2) that the bank was “essential to provide adequate banking service in its community.” 12 U.S.C. § 1823(c) (1976). That provision remains in the Act as Section 13(c)(4)(A), 12 U.S.C. § 1823(c)(4)(A) (1982). But Garn-St Germain also authorized the FDIC to provide such direct assistance to a failing bank whenever that is the cheapest way for the FDIC to handle the failure. *Id.* Section 13(c)(4)(A) provides in relevant part that “[n]o assistance shall be provided . . . in an amount in excess of that amount which the Corporation determines to be reasonably necessary to save the cost of liquidating . . . .” When direct assistance is the low-cost solution, the essentiality finding is no longer necessary.

17. P. x.

transaction, usually referred to as a purchase and assumption (P&A), has several advantages. It preserves the going-concern value of the failed bank, which stays in operation. The community thus benefits from the continued availability of banking services. This approach is usually cheaper for the FDIC. It saves the administrative costs of paying insured depositors; more important, the acquiring bank is usually willing to pay a premium for the acquisition. And, most important, the P&A protects all depositors, even those with accounts of over \$100,000. They become depositors of the acquiring bank.

Because of these advantages, when a bank fails the FDIC almost always tries to arrange such a transaction, particularly if the bank is large. But there is one major disadvantage to P&A approach. Its protection of all depositors tends to reduce market discipline. If depositors expect that in cases of failure they will be protected by a P&A, then they have no incentive to select their bank on the basis of its financial soundness.

Sprague notes that nearly all bank failures are handled by one or the other of these two methods. But there is the authority, under section 13(c) of the Federal Deposit Insurance Act (FDIA)<sup>18</sup> for the FDIC to make a loan or provide assistance in some other way directly to the failing bank. This authority has been used only rarely. Such assistance can be a wind-fall to stockholders or management of the failing bank, who might be far worse off if the bank were permitted to fail. Sprague was a member of the Board when this authority was used for the first time and when it was used in the largest bank failure in history. These cases provide a useful focus for Sprague's book. These are the cases that Sprague calls "bailouts."

## II. Assessing Bailouts and *Bailouts*

During most of Sprague's term on the FDIC Board, such 13(c) assistance required the "essentiality" finding. The oral tradition when I was at the FDIC was that this provision was added to the FDIA in 1951 to provide for the situation in which the bank in an isolated one-bank town was failing.<sup>19</sup> It was believed that lack of a bank could be damaging to the local economy. In that case, 13(c) allows the FDIC to keep the bank in operation.

18. 12 U.S.C. § 1823(c)(4)(A) (1982).

19. In an article on the Unity Bank decision, H. Erich Heinemann argued that 13(c) was a provision "that Congress had in mind [for] small, isolated rural communities . . ." See Heinemann, *Black Banking: Participation of F.D.I.C. in Assisting Boston Institution Raises Questions*, N.Y. Times, Aug. 4, 1971, at 43, col. 7.

While the legislative history is not entirely clear, I believe the traditional interpretation of the legislative intent was probably correct. However, this interpretation of “essentiality” makes little economic sense. If a bank is failing because of incompetent management or fraud, then direct assistance is not necessary—economic incentives will lead to the establishment of a new bank to replace the failed one. And if a bank’s failure is due to the absence of economic demand for it, it is hard to conclude that it is essential.

In none of the cases considered by Sprague (or any of the other 13(c) cases handled by the FDIC) has the test of essentiality been met, as that term might be understood by economists or ordinary users of the English language. While Sprague recounts the FDIC’s efforts to justify findings of essentiality, the fact is that a bank is “essential” whenever the FDIC Board says it is. Since the use of 13(c) results in all creditors being protected, there are no adversely affected parties who might press for judicial review of the finding.<sup>20</sup>

In the first use of 13(c), Unity Bank of Boston, a small, black-controlled bank in Roxbury was saved from failure (though only temporarily) by an FDIC loan. The effort to save Unity was certainly well-intentioned, even if the F.D.I.A. never contemplated such an action. Sprague notes that finding Unity to be “essential” was difficult “since other banks had branches in Roxbury not far from Unity.”<sup>21</sup> In the end, what carried the day were considerations related to the effect of failure on perceptions of the Nixon Administration’s minority enterprise program and a possible appearance of insensitivity to minority problems.

Sprague exaggerates the significance of the Unity case when he calls it “the precedent that would lead to the Continental solution thirteen years later.”<sup>22</sup> Unity was a precedent only in the sense that it came before Continental. But Unity did not make the decision to bail out Continental inevitable. The FDIC could have saved Unity on the basis of the policy considerations that it did rely on, and found another solution for Continental. And assistance could have been justified for Continental even if Unity had been allowed to fail. I doubt that as Stan Silverberg, head of the FDIC’s negotiating team, met with investment bankers and potential buyers of

20. As in any insurance context, the critical observer must ask whether the rescued bank’s *co-insureds* are in fact “adversely affected parties who might press for judicial review.” However, this question ignores the fact that the co-insureds are not “paying” for the bailout since the bailout saves money, i.e., is only employed as a strategy by the FDIC after it has determined that it is cost-effective. Although the FDIC may fudge on the “essentiality” finding in its decision to bail out a bank, it always attempt to meet a cost-benefits test under which the avoidance of the risk of financial panic is counted as a benefit.

21. P. 43.

22. P. 49.

Continental, he was giving much thought to the "precedent-setting" decision made in 1971.

In fact, the real precedent-setting decision has yet to be made—the decision to allow depositors to take a loss in a large bank failure. The Bank of the Commonwealth (BOC) case was handled to avoid this result. In BOC, as in all large-bank cases, the Federal Reserve pressured the FDIC to avoid a payoff. Sprague notes that the Federal Reserve's fear that the failure of a large bank would lead to the failures of other banks is a "domino theory we still have not tested in the real world."<sup>23</sup> The Federal Reserve has the principal responsibility for maintaining financial stability, so it is not surprising that the Fed seeks to avoid any risk of triggering financial panic. It is unfortunate, however, that the Federal Reserve so consistently underestimates the stability of the financial system.<sup>24</sup>

The FDIC would have preferred a non-13(c) solution to BOC, but Michigan's branching law and banking structure<sup>25</sup> precluded that. Despite Sprague's description of agonizing over the essentiality finding, the conclusion was inevitable. This is best illustrated by Sprague's comment that "whenever 'essentiality' would come up, I would shake my head. They were not going anywhere without that essentiality finding."<sup>26</sup> Yet on the very next page, after a discussion of agreement on a satisfactory financial package to save BOC, Sprague says, "I was prepared to vote for essentiality."<sup>27</sup> But nothing changed between pages 71 and 72 to make BOC more essential to its community.

Two large bank failures occurred in the mid-1970's—U.S. National Bank of San Diego (USNB) and Franklin National Bank of New York. Both of these were handled as traditional P&A's, though USNB was not a traditional candidate for a P&A. When there is suspicion of fraud, so that the bank's books cannot be relied on, the FDIC is reluctant to provide the indemnification that a buying bank demands. The purchaser

23. P. 68.

24. The examples of this cited by Sprague are convincing. It is also instructive to consider the discussion of large-dollar electronic payments systems by Federal Reserve Bank of New York President Gerald Corrigan in G. CORRIGAN, *FINANCIAL MARKET STRUCTURE: A LONGER VIEW* (1987). Corrigan is concerned that the failure of a single participant in such a system carries the risk of causing a collapse of the entire payments system. This possibility is treated as self-evident, with no attempt made to document how such a result could occur. While I would by no means suggest that, left to their own devices, any FDIC Board would have allowed the closing and liquidation of a very large bank, it is likely that the consistent pressure of the Federal Reserve in the direction of avoiding such results did have an influence.

25. Antitrust considerations precluded acquisition by another Detroit bank, while a bank from outside Detroit could not operate BOC's offices as branches. Furthermore, it seemed unlikely that a buyer for a failing minority bank in an area not desirable as a business location would be found. For a general discussion of these problems, see p. 38-52.

26. P. 71.

27. P. 72.

assumes all liabilities—disclosed and undisclosed—and if the books do not reflect all the liabilities, the FDIC is exposed to an unlimited potential loss.<sup>28</sup> The FDIC suspected fraud in USNB but did the P&A anyway to avoid the failure of a billion-dollar bank. The rationale was the same as in the 13(c) cases—avoid a loss to depositors in a large bank failure.

Stretching to find essentiality reached an extreme in the First Pennsylvania case. Philadelphia was well-served by a number of banks, large and small. In describing this case, in fact, Sprague barely mentions the finding of essentiality, reporting in one short paragraph that the FDIC general counsel advised the Board that they could make such a finding if they wanted to. Sure they could—no one with the incentive to sue had standing to prevent them.<sup>29</sup>

The major event in *Bailout* is, of course, the rescue of Continental Illinois. While the FDIC did reach (though never released) a finding of essentiality, such a finding was not necessary. The Garn-St Germain Act<sup>30</sup> included a provision<sup>31</sup> that, in effect, changed the law to conform to what the FDIC had been doing all along. The law now allows the FDIC to provide direct assistance when such assistance will be cheaper for the FDIC than a payoff. In that context, the resolution of Continental was logical, even if one believes that banking service would be adequate in Chicago without Continental.

The results of Continental (as well as the other 13(c) cases described by Sprague) belie the use of the term “bailout.” The effect on stockholders was almost equivalent to a failure—they were wiped out unless they invested new funds. Depositors were protected in full, but this would have been true even in a P&A. Top management was forced out (though they were allowed to retain their “golden parachutes”). Criticism has been aimed at the fact that the deal did, however, provide protection for creditors of the holding company. This was a particular concern of the Treasury Department.<sup>32</sup>

28. In a payoff, the FDIC is exposed to risk of undisclosed *insured* deposits only, and its loss is shared with the uninsured depositors. If, after an P&A is arranged, a party turns out to have a legitimate claim against the failed bank, then the FDIC must cover that loss in full. In fact, that turned out to be the case, as letters of credit issued by USNB were held to be liabilities of the bank.

29. See *supra* note 20.

30. Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12 U.S.C.).

31. Section 13(c)(4)(a), 12 U.S.C. § 1823(c)(4)(A) (1982).

32. The reasons for the Treasury Department's opposition are not clear. It may have been a pure turf battle, or, as Sprague suggests, an attempt by the Administration to distance itself, in an election year, from the potentially costly bailout of a big bank. A possible explanation may lie in Treasury's concern that extending protection to affiliates of a failed bank could undermine Treasury's efforts to gain broader powers for commercial banks, with such powers to be exercised through separate subsidiaries which would not have the advantage of federal deposit insurance. If bank affiliates were to have *de facto* deposit insurance protection, competitors of banks would have an argument against the broadening of bank powers.

## Conclusion

It is interesting that Treasury officials are the only people criticized in the entire book.<sup>33</sup> Sprague has no criticism of any officials of any of the banking agencies he worked with, or of other FDIC Board members, or of FDIC staff.<sup>34</sup> Only Treasury personnel get negative marks as to competence, professionalism, or motive.<sup>35</sup>

Sprague is right in rejecting the Treasury view that we should not extend deposit insurance protection to holding company creditors. In general, of course, the Treasury is right about that. Public policy concerns about financial stability go to the *bank*, and not to the parent holding company. While losses to bank creditors might conceivably spark financial panic, losses to holding company creditors are unlikely to have such an effect. In this case, however, as Sprague points out, "the issue was largely academic at Continental since the holding company had other assets roughly equal to its liabilities even if its investment in the bank was valued at zero."<sup>36</sup> That is, even if the FDIC acceded to Treasury wishes, the holding company creditors would have come out whole.

The actual solution in Continental was excellent, in financial terms, for the FDIC. What was done was better than the justification offered by Sprague for keeping Continental alive. Sprague repeats the claim originally made by the Comptroller of the Currency that failure of Continental would have caused the failure of fifty to two hundred<sup>37</sup> other banks that had deposits with Continental. But that calculation was based on an assumption that these deposits in Continental would become a total loss. As George Kaufman has documented, such statements greatly exaggerate the potential disruption of a large bank failure.<sup>38</sup> The Continental solution could be defended on a pure FDIC cost-minimization basis, without raising the red herring of widespread banking collapse.

33. *E.g.*, Pp. 182-99 (discussing Treasury opposition to Continental rescue and concluding that Treasury "started out by confusing oranges and apples and it was all downhill from there").

34. When Sprague seeks to document the problems of inter-agency conflict, he does not cite any examples from his own years at the FDIC, but goes back to conflicts involving Comptroller of the Currency James Saxon, years before Sprague had any connection with bank regulation. This is particularly peculiar, since most authorities seem to agree that in most of these conflicts, Saxon was right. In any case, it is hard to understand how one who worked closely with Paul Volcker could characterize Saxon, as Sprague does, as "the consummate turf protector." P. 236. Sprague seems to go out of his way to avoid speaking ill of the living.

35. When I first read the book I was surprised at the characterization of Donald Regan. He had always been portrayed in the press as a strong manager in full control of subordinates. The somewhat erratic operations of Treasury staff depicted by Sprague seemed inconsistent with this picture. Recent developments suggest that Sprague is on the mark, and that President Reagan might have benefitted from reading *Bailout* before appointing Regan as Chief of Staff at the White House.

36. P. 189.

37. P. 155.

38. See Kaufman, *Bank Failure Fears Are Overdrawn*, Wall St. J., Oct. 12, 1984, at 30, col. 4.

Sprague seems to realize that the real issue is not bailouts but rather the disparate treatment of large and small banks, and the conflict between our desire for market discipline and the fact that market discipline means risk of instability—the market exercises its discipline by moving deposits out of weak banks.

Sprague does not sufficiently stress that even under current procedures, direct assistance does not necessarily involve a bailout of the banks we do not wish to protect. Stockholders in all the cases discussed by Sprague were virtually wiped out. In First Pennsylvania the stockholders did make a substantial recovery, but the FDIC, through its taking of warrants, also profited handsomely from the recovery of the bank. Top management responsible for or associated with the failures were removed in all cases except First Pennsylvania.

There is a place for open-bank assistance. It worked in First Pennsylvania and Continental. But it should not be impossible to find a better way to deal with large bank failures. Sprague provides only a brief and rather unsatisfactory discussion of the alternatives. He supports a combination of the “modified payoff” approach experimented with by FDIC in 1984 (for small banks) and a “bridge bank” approach in which the FDIC could temporarily take over operation of the bank (for large banks). There is no discussion of the “modified trusteeship” plan developed by Kaufman, which involves a bridge bank with a “haircut” or loss imposed on uninsured depositors.<sup>39</sup> Losses to depositors in large banks may provide a useful discipline. Sprague admits that “three times I blinked when faced with what would have been the largest bank failure in history—Commonwealth, First Pennsylvania, and finally Continental.”<sup>40</sup> That is a more honest assessment than much of the book’s description of indecision and agonizing over essentiality.

Sprague has given us an intriguing glimpse into the FDIC’s concerns and methods. But he has left unresolved the means of handling large bank failures other than waiting to see who blinks first.

39. See G. BENSTON, R. EISENBEIS, P. HORVITZ, E. KANE & G. KAUFMAN, *PERSPECTIVES ON SAFE & SOUND BANKING: PAST, PRESENT, AND FUTURE* 106 (1986).

40. P. 244.

