Steven P. Watten
Strasburger & Price, LLP
2801 Network Boulevard
Suite 600
Frisco, TX 75034
(469) 287-3939
Steve.Watten@strasburger.com
vCard
Bio
Website

LinkedIn
Twitter
Blog
JD Supra

Connecting the Dots: The "New" U.S. Banking Crisis Policy; Also, Potential New Equity Source for Community Banks

June 30 marked the end of the first half of 2010. Eighty-five banks have failed in 2010. At the current rate, failures for the year could total 170. The number is significant in two contradictory respects. First, the number is extraordinarily high. One hundred seventy bank failures would be the highest number since 1992 when 182 banks collapsed. Second, the number when compared to the 1980s indicates a wholesale change in federal crisis policy.

Since 2008, the regulatory agencies, two presidential administrations and Congress have been engaged in an effort to not only avoid another Great Depression, but also to avoid the massive failure of banks experienced in the S&L Crisis.

The '80s: Texas Burned

In the 1980s Texas was the epicenter of a commercial real estate binge and the resulting carnage that devastated the banking industry. Of the 2,700 banks and thrifts which failed in the U.S. during that crisis, 599 or 22% were in Texas, including 9 of the 10 largest Texas banks. The failure of these large institutions in 1988 and 1989 meant that during those two years Texas banks accounted for 85% of U.S. failed bank assets.[1] During the broader period, 44% of the banking assets in Texas—which today has an economy equivalent to Canada—were vaporized.

The approach in the '80s was to let the Texas fire burn itself out The blaze was ignited by a combustible mixture of (a) abnormally high interest rates enlisted to defeat inflation, (b) deregulation of savings and loans, (c) the chartering of 673 new Texas banks and S&Ls—21% failed[2], (d) the crash of the energy industry, (e) tax cuts used to pull the nation out of severe recession which gave favorable tax treatment to CRE in the form of accelerated depreciation and deductibility of passive losses, (f) dramatic overbuilding resulting in a combined office vacancy rate in Dallas, Houston, San Antonio and Austin in excess of 30%[3], (g) a lack of transparency in the commercial real estate market, (h) a get-rich-quick mania, and (i) fraud.

In the end, 599 Texas banks and savings and loans perished. Former FDIC

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1 www.fdic.gov, History of the Eighties—Lessons for the Future, p. 321
2 Ibid, p. 313; Also FDIC Banking Review 3, no 2 (winter 1990), The Texas Banking Crisis: Causes and Consequences 1980-1989, by John O'Keefe. p. 1
3 O'Keefe, p. 7

	Chairman William Seidman said, "There is little evidence that the future will change human nature and its weakness for over-enthusiasm, excessive pursuit of gain and [the] tendency of mankind to be secretive." In an attempt to resolve the crisis a massive federal agency, the Resolution Trust Corporation (RTC), was created. It was not an emergency room for real estate loans and banks, but a mortuary. It collected the assets of failed banks and thrifts and sold them to the private investors, flooding the market with properties. The result was distressed real estate in some cases sold for ten cents on the dollar. The fire sale of the assets of failed institutions further damaged the real estate market. At the end of the crisis the assets of failed U.S. banks totaled $1.1 Trillion in 2010 dollars. The effect on the Texas economy was devastating. The state's GDP growth rate—which exceeded the U.S. rate until mid-1982—trailed the U.S. for the next decade with the greatest difference in 1986 when the U.S. rate was plus 3% while Texas' rate was minus 3%. The two rates did not mirror each other again until 1992.[4] Median home resale prices in Texas fell below the US from 1985 to 1990 by as much as 33%.[5] As the banking crisis moved into the 1990s the FDIC's approach changed and by the mid-1990s the FDIC's preference was to transfer the assets of failed banks to new acquiring institutions for the following reasons: "First... accumulation of assets would have a disastrous effect on the insurance fund...Second...it was generally believed that after an asset from a failing bank was transferred to a receivership, the asset would suffer a loss in value...Third, as the FDIC began having to manage an extremely large portfolio of failed bank assets...several logistical problems began to develop, and it therefore became more desirable to pass assets to acquirers rather than incur the added costs of acquiring, maintaining, and subsequently remarketing those assets. Fourth, the FDIC simply considered it more appropriate for private assets to remain within the private marketplace...Finally, the FDIC saw the sale of higher percentages of assets at resolution as a way to minimize disruption in the communities in which failing banks were located."[6] In December 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act. It established five capital level classifications [CAMELS] for banks, with sanctions prescribed as an institution's capital declined. "FDICIA also influenced the FDIC to reduce

4 www.fdic.gov, History of the Eighties— Lessons for the Future, p. 294
5 Ibid, p. 307
6 www.fdic.gov, Evolution of the FDIC's Resolution Practices, p. 87
7 Ibid, p. 93
8 The American Banker, GAO Audit Shows Errors in FDIC Loss Estimates, June 29, 2010.
9 FDIC Banking Review, 2006, Volume 18, No. 1, Troubled Banks: Why Don't They All Fail?, p. 29; Conversely 96% of all banks which ultimately failed were first on the troubled bank list.

its resolution costs by allowing the FDIC to sell asset pools to banks that were not assuming the deposits, selling a failed bank's branches to different banks, and entering into loss sharing agreements on certain asset pools."[7]

Therefore, in 2008 when the Great Recession began to impact banks, the federal approach in the 21st Century was far different than that of the 1980s.

The New Century: The New Tools & The New Strategy

1. **TARP** – While public attention has been focused on the massive aid given to the money center banks, AIG, General Motors and Chrysler, TARP funds were also used to purchase preferred stock in over 600 banks. The injection of capital was received by regional banks [assets greater than $10 billion], mid-sized banks [assets $1 to 10 billion] and community banks [assets less than $1 billion]. In an earlier Banker's Alert the former head of the OTS Central U.S. Region, Fred Casteel cited capital as the major factor which determined which banks died and which lived in the Eighties. Recently The American Banker reported that community banks, in contrast to money center banks which quickly paid the TARP funds back, are holding onto the funds out of necessity.

2. **No RTC –** The FDIC has acknowledged the RTC was an Ineffective tool for the resolution of a banking crisis. The assets sold by the FDIC contained imbedded unrealized gains. The gains were reaped solely by the private parties who purchased the properties at below their intrinsic value leaving the taxpayer with the losses. The fire sale of an enormous volume of commercial real estate further eroded property values in the affected areas.

3. **Loss Sharing Agreements –** First available in 1991, his structure has become the dominant model for the FDIC in the 21st century, with the FDIC sharing future losses and profits with the purchasers of bank assets. In the 140 bank failures in 2009 loss sharing agreements were utilized by the FDIC 90 times. Current FDIC Chairwoman Sheila Bair has stated, "We estimate the cost savings have been substantial; the estimated loss rate for loss share failures average 25%; for all other transactions it was 38%". "If we tried to sell the assets of failed banks into today's markets, the prices would likely be well below their intrinsic value."[8] In an interesting development in one recent transaction, the FDIC reduced the percentage of losses it would bear from an 80-20 split (given in other transactions) down to 50-50.

4. **Workouts Allowed**—The agencies CRE Policy Statement of October, 2009.

A. On October 30, 2009 the agencies jointly issued the "Policy Statement on Prudent Commercial Real Estate Loan Workouts." Bair stated, "It emphasizes that restructured loans will not be subject to adverse classification by examiners solely because the value of the underlying collateral has fallen..."

B. In the months following the issuance of the guidelines, Federal officials have repeatedly emphasized the Policy Statement:

i. Fed Chairman Ben Bernanke in Dallas on April 7 specifically mentioned the Policy Statement in his speech and added, "We also must support sensible efforts to work with troubled borrowers to bring them back into good standing."

ii. Fed Associate Director of Bank Supervision Jon Greenlee, January 2010, "If a borrower can continue to make payments at a certain level, that is a better outcome than foreclosure for both the bank and the borrower."

iii. Fed Governor Daniel Tarullo, New York City, April 8, "If you believe that we are not implementing the terms of this guidance, please let us know and give us the details."

iv. Sheila Bair, "The FDIC is also training our examiners to make sure that they are accurately applying the guidance in the field."

5. **Forbearance on the CRE Concentrations**

Consistent with the Policy Statement is an effort by the agencies to allow most banks to work through their commercial real estate problems by allowing those banks which are not in compliance with the agencies' December 2006 guidelines on concentration of CRE time to reduce those concentrations. The 2006 guidelines stated that banks should not allow CRE loans to exceed 300% of capital and construction and land loans should not exceed 100% of capital. Currently 3,000 banks exceed those guidelines.

According to Comptroller of the Currency John Dugan, "I think we need to revisit the issue of the appropriate regulatory response to CRE lending concentrations." However, he added, "Any course of action would have to be carefully *phased in* taking into account the current activities of all banks...We should not do any of this in haste, or in ways that would exacerbate the current problems of distressed banks." (Emphasis added)

Fed Governor Tarullo in his April 8 speech stated, "[W]e expect bankers in

	the coming years to try to escape and then avoid high loan concentrations...” (Emphasis added) In response to our inquiry, FDIC Director of Supervision, Sandra Thompson, stated in a May 14 letter, the 2006 *Concentrations in Commercial Real Estate* “...did not state that CRE concentration definitions are lending limits; rather it defines CRE concentration benchmarks from a regulatory standpoint...The FDIC does not anticipate changes to CRE concentration guidelines, or the tenets set forth in the document *at this time*....” “With regard to your second question whether banks are being provided with a transitional period to reduce their CRE exposures before more stringent lending guidelines are imposed, we do not expect that regulatory guidelines for CRE will change *in the near term*.” “While we have been recommending that certain institutions revisit their asset concentrations given outsized exposures to CRE lending, we are not directing banks to curtail CRE lending in a broad sense. Conversely, the agencies have been encouraging banks to work with borrowers experiencing difficulty making payments and continue originating CRE loans in their markets as described in the *Policy Statement on Prudent CRE Workouts* which you cite. We, as you, understand the public’s concerns about credit availability and are hopeful that financial institutions continue prudent lending operations to hasten an economic recovery.” (Emphasis added) 6. **Note Sales –** Rather than retention of troubled loans in a massive government agency like the RTC, the FDIC is conducting bulk sales of loan portfolios. This is consistent with Seidman’s speech in Tokyo in 1996, in which he emphasized the need to keep such assets in private hands or return them quickly to the market. 7. **Discounts of Preferred Stock** – In TARP, in return for the infusion of capital into banks the U.S. Government received preferred stock in the recipient banks. The Treasury Department recently has been selling such preferred stock at a discount to investors who purchase troubled financial institutions before they fail. 8. **Securitizations** – The FDIC also is securitizing portfolios of performing and non-performing loans and selling the securities in the open market. 9. **Delayed Sales of** MBS – A *Wall Street Journal* article on May 20 reported that “[A majority of] Federal Reserve officials...opposed selling mortgage backed securities bought by the Fed to combat the recession.” “[T]he Fed flooded the financial system with cash by buying $1.7 trillion [of such securities].” The story states that such sales are not expected until

the economy recovers and interest rates rise.

10. **Zero Interest** – In December, 2008, the Fed rapidly dropped interest rates to near zero as the crisis deepened. According to William Seidman, "[One of the] lessons to be noted...[T]he [benefit of] use of monetary policy to keep interest rates low [to] aid wounded banks to recover." During the 1980s short term interest rates raised by the Fed approached 20% and were not reduced until after the Texas real estate market was in ashes.

The FDIC's Prediction on 2010 Bank Failures

In a CNBC interview with Maria Bartiromo on March 29, FDIC Chairwoman Bair expressed her view *that failures in 2010 would exceed 140 but "[n]ot a lot higher than that*...it will *peak in the third quarter* and toward the end of the year we'll be seeing the light at the end of the tunnel... Banking recovery generally lags economic recovery because it takes some time for credit losses to work through the system. And of course all these statements are conditioned upon what happens to the economy." (Emphasis added)

We now enter that third quarter.

The current figure for total bank failures since the start of the Great Recession stands at 258. Approximately 1,300 banks are operating under letter agreements with federal banking regulators restricting their operations in some manner. In more serious condition are the 775 banks on the FDIC's troubled bank list. In the FDIC's quarterly report for the first quarter of 2010, "Chairwoman Bair noted that the vast majority of 'problem' institutions do not fail." That statement is consistent with the FDIC studies which show that the percentage of banks on the troubled bank list which ultimately fail is less than 5%.[9]

If Bair is correct and bank failures peak this year, it is possible that total bank failures in the Great Recession could be 400 or less, which would be less than 15% of the figure for bank failures in the S&L Crisis. That development would be a positive factor in the effort to return the national economy to normalcy.

New Capital for Community Banks: The Small Business Lending Fund Program

What the forbearance policies do not address is U.S. unemployment. Eighty-five percent of new jobs in a recovery are believed to be created by small business. Forty percent of the credit obtained by small business comes from community banks. However, the current condition of community banks, with over 1,300 operating under letter agreements with the agencies restricting their lending activities or operations and others hesitant to lend, small business lending is at a standstill impairing the recovery.

To address this problem Congress is considering a one year $30 billion program to inject capital into community banks for the specific purpose of providing them with the funds to lend to small businesses. The act creating the Small Business Lending Fund Program [H.R. 5297] was passed by the House on June 17. On June 29 on a motion by Rhode Island Senator Jack Reid the House bill was committed to the Senate Committee on Finance.

The bill would authorize the Treasury to purchase preferred stock and debt instruments from eligible institutions [asset size of $10 billion or less]. The capital investment in an individual institution would be in an amount not to exceed 5% of the institution's risk weighted assets for institutions with assets of $1 billion or less and up to 3% in the cases of institutions with asset size great than $1 billion but less than $10 billion. Institutions on the FDIC troubled bank list would be barred from the program.

The financial institutions would then be incentivized to make small business loans as follows: (a) a baseline would be established for the bank's small business lending based upon its call reports for the 4 quarters immediately preceding the date on which the law is enacted, (b) if during the first two years after the Treasury's purchase of equity or debt in the bank, the bank's small business lending increased by less than 2.5%, the bank would be charged the standard 5% dividend or interest rate, (c) if it increased by 2.5% > 5% the rate would drop to 4%, (d) a 5 > 7.5% increase would drop the rate to 3%, (e) at 7.5 > 10%, the rate would drop to 2% and (f) with a 1 0 % or more increase, a 1 % rate would be charge. From year 2 until 4.5 years after the capital investment, the rate would set based upon the amount of small business lending in the 8th quarter following the Treasury investment. If the bank's small business lending stagnated or went down after the 8th quarter, its interest rate would rise to 7%. The bank would be incentivized to repurchase its stock or bonds by an interest rate of 9% after the 4.5 year mark with a final maturity of 10 years. The stock or bonds could be used by an eligible bank to pay back an investment made by the Treasury in the bank's preferred stock under the TARP program.

The Risk of a "Lost Decade"

Some argue a policy of governmental forbearance could result in an economic malaise. Japan's economy in the 1990s went through the so-called "Lost Decade." Policy makers are clearly attempting to thread the needle; prevent the failure of thousands of U.S. banks while escaping the economic fate of Japan. Examinations of the "Lost Decade" and whether or not the U.S. will repeat it can be found at:

- IMF Working Paper, "Lost Decade" in Translation: What Japan's Crisis could Portend about Recovery from the Great Recession", Murtaza Syed, Kenneth Kang, and Kiichi Tokuoka, at www.imf.org
- "Lost Decade Here We Come" and "Lost Decade Looming?" Paul Krugman, http:krugman.blogs.nytimes.com
- "Japan's Lost Decade," Justin McCurry, www.guardian.co.uk
- "Japan's Lost Decade," John H. Makin, www.aei.org
- "Japan's Lost Decade," Eric Weiner, www.npr.org