Déjà Vue all over again?

By: Bill Gray. ***This was posted Friday, August 21st, 2009***

It is the mid-1980's. Savings & Loan institutions are failing at an alarming rate. So many are insolvent, in fact, that the Federal Savings & Loan Insurance Corporation (FSLIC), the deposit insurer of thrifts at that time, is running out of money to close insolvent thrifts. What does FSLIC do? It seeks out purchasers, who will buy, or recapitalize, a failing thrift. To entice such purchasers, FSLIC agrees to grant valuable financial inducements to the purchasers, including "forbearances" in counting bad loans against capital requirements, or allowing "goodwill" to count towards capital requirements.

The program worked well — several hundred "deals" were struck, in which insolvent institutions were taken over by purchasers who were given the many incentives. Thus, FSLIC did not have to close those institutions.

Happy ending to the story? Not by a long shot.

In 1989, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA"). Among other things, FIRREA immediately took away all the incentives FSLIC had given to the purchasers of insolvent thrifts. With the incentives taken away, many S&L's were immediately insolvent, since suddenly all bad assets did count against capital, and goodwill could not be counted toward capital. Millions of dollars were lost by those who were initially given the FSLIC promises.

Lawsuits were, of course, filed, commonly, known as "Winstar" or "Goodwill" litigation. In *United States v. Winstar* (hence, the "Winstar" reference), the Supreme Court ruled that FIRREA breached the forbearance agreements FSLIC had given. However, the litigation proceeded for years on the issue of the amount of damages the Government had to pay, if any.

Fast forward to Summer, 2009. The headlines declare the Federal Deposit Insurance Corporation (FDIC) is now low on funds, since once again banks are failing at an alarming rate. Once again, the headlines say the FDIC wants to "attract" buyers of failing banks (and more here). To do so, it is willing to offer deals and incentives. (Sound familiar?) One such incentive may be to soften regulations on allowing private equity firms to buy failing banks. Traditionally, the FDIC was wary of private equity buying banks, for fear they will engage in more risky lending, or only be a short-term investor in an industry that many believe requires stability.

The FDIC Board will soon decide how it will address its problem of the depleted deposit insurance fund, and the increased number of bank failures. Other proposals are being considered in addition to the private equity solution. But with history as our guide, any prospective purchaser willing to accept "inducements" in purchasing a failing bank, should be very cautious, or at a minimum recognize its risks.