FAILED BANKS,FDIC & PUBLIC BENEFIT BANKS

The United States is seeing an explosion of bank failures. FDIC, the agency tasked with banking oversight and protection of depositors, is being overwhelmed.

And the worst is yet to come.

The agency has nearly exhausted its funds and will shortly have to take extraordinary measures to continue its mandate. Simultaneously, many communities, businesses and individuals are being negatively impacted by these bank failures.

Can anything be done to:

- Help stem the tide of bank failures?
- Reduce the increasing outlay of funds from FDIC?
- Slow or reverse the negative impacts on local communities and our economy?

We think so.

A potential new option for FDIC lies in the introduction of a new kind of bank ownership model, whereby government agencies and non-profit organizations take over failed banks.

We call these new banks Public Benefit Banks. Their introduction could rescue many banks that would otherwise close and potentially save FDIC hundreds of millions, if not billions of dollars.

First, some background.

FAILED BANKS A GROWING THREAT

The article *Regulators Seize 2 Banks; 94 Failures This Year*[1] (Huffington Post, 9/18/09) highlights an alarming trend. The story came on the heels of another report, *Problem Bank List Hits 15-Year High*[2] (Huffington Post, 08/27/09), which revealed that "Eighty-one banks have failed so far this year. Hundreds more are expected to fall in coming years largely because of souring loans for commercial real estate. [FDIC] also said the number of banks deemed to be in trouble jumped to 416 from 305 at the end of the first quarter. That's the highest number since June 1994. Total assets of troubled institutions surged to $299.8 billion from $220 billion in the first quarter."

According to FDIC Chairman Sheila Bair, appearing on *Your Bank Has Failed*,[3] (CBS' 60 Minutes, 3/8/09), only 25 banks failed in 2008 (three in 2007). Predictions for 2010 are worse than 2009. FDIC is rapidly running out of funds, as noted in *FDIC to Consider Ways to Replenish Deposit Fund*[4] (Reuters, 9/18/09), and fee increases to member banks only add to failure pressure, especially on the smaller banks.

[1] *http://www.huffingtonpost.com/2009/09/19/regulators-seize-2-banks-_n_292138.html*
[2] *http://www.huffingtonpost.com/2009/08/27/problem-bank-list-hits-15_n_270344.html*
[3] *http://www.cbsnews.com/stories/2009/03/06/60minutes/main4848047.shtml*
[4] *http://www.reuters.com/article/americasRegulatoryNews/idUSN1825028520090918*

One way FDIC tries to reduce its costs is to sell failed banks to other banks, even though the agency remains on the financial hook for as much as five to 10 years through loss guarantees it provides to buyers.

However, the bank failure problem is not across the board. Chairman Bair has pointed out that the system favors large banks and agrees with Fed Chairman Ben Bernanke that it actually hurts smaller banks.

FDIC would prefer limiting banks from getting too big to fail, she said, yet bank failures only exacerbate that trend as larger banks gobble up the smaller failed banks and thereby grow even larger. And as the failure rate grows, FDIC is finding fewer healthy banks willing to buy failed institutions, especially smaller community banks, leaving the remaining buyers to focus on the larger failed banks, thereby enabling them to get much bigger, faster.

This trend means that more and more community banks will disappear entirely (FDIC doesn't have the resources to keep running an ever-increasing number of banks, one of its current options), further depressing local economies.

Such failures not only cost the FDIC and its member banks (and potentially taxpayers when FDIC runs out of funds), but have a dramatic ripple effect in communities. Community banks keep money circulating within their communities, whereas national banks (what's left over after a local bank fails) are well known for moving money out of local economies. What can be done?

A SOLUTION: PUBLIC BENEFIT BANKS

Let's examine what happens when a bank fails. FDIC currently has three options: shut down the bank and pay off its depositors; take over and keep running the bank; or seize it and sell it to third parties but remain on the hook for substantial, long-term loan loss guarantees (loss-share agreements) to the buyers for 80-95% of the loss.

A fourth — and better — option is desperately needed, especially for community banks so often crucial to local economies. We believe we have found that option —what we call Public Benefit Banks. In essence, a PBB is a bank owned and operated by either a government entity (state, county or local government) or a non-profit organization.

A PBB exists to exclusively serve the public good rather than private interests, and all profits inure to the benefit of its community or state. They operate just like any other bank, except that they are "owned" by the public through the government or a non-profit organization, rather than private shareholders.

For an in-depth analysis of the Public Benefit Bank concept, see CalGreen Bank on the CEED Program website.

AN INTER-PUBLIC TRANSFER

So how would this "public" ownership constitute a solution to the problems generated by failed banks? The key is that the federal government can, as the de facto owner of a failed bank (existing shareholders are removed and FDIC becomes the sole owner) dispose of the bank in any way it deems appropriate.

Our new option would "give" the bank to another government entity and/or a non-profit. FDIC can legally do so as those entities are, like the FDIC itself, "public" entities dedicated to the public good.

Such entities could continue to operate those banks, just like the FDIC could, provided that they have the additional resources and expertise needed to keep the banks running. In the event that the failed bank is operating with a current negative cash-flow but has the potential to return to positive conditions, then the FDIC could provide the necessary financial resources to keep the bank running for a limited period of time. This would incur a substantially lower cost than that required to close the bank.

It is important to note that a significant number of FDIC-seized banks got into trouble primarily from an accounting standpoint and not a current cash-flow standpoint. That means they are generating enough cash to keep their operations afloat (pay their rent, employees, etc.), but do not have sufficient capital or reserves to satisfy regulators' requirements to continue to operate in what is considered a safe and healthy manner for a privately held bank. A PBB could continue to run such a bank under FDIC oversight while restoring it to a safe and healthy condition.

WHY PBBS CAN THRIVE WHERE PRIVATE BANKS CAN NOT

For-profit banks are reluctant to devalue their loan portfolios because of the impact on their perceived value (especially if they are public corporations), which also impacts their loan limits, even though that means that the real health of their loan portfo-

lios might not be properly recognized. We see this on Wall Street where banks are reluctant to properly value the "toxic assets" on their books fearing negative market and regulator reaction, resulting in unhealthy distortions and negative consequences.

PBBs, on the other hand, would not be concerned with their stock price, but only with their ability to lend to their customers. Therefore they would have less concern about having the real health of their loan portfolios reflected in their books, and they and the FDIC would better serve the public by a valid recognition of their portfolios' true value.

Therefore, FDIC could allow and even encourage PBBs to write down or write off loans, or to renegotiate loan terms to reflect borrowers' ability to pay given current economic realities, and not penalize the banks through the lower lending limits that would normally result from lower-value loan portfolios.

The FDIC is already encouraging buyers of failed banks to renegotiate loans (FDIC Encourages Loss-Share Partners to Provide Forbearance to Unemployed Borrowers,[5] (FDIC, 9/11/09)). Keeping buyers in their homes and businesses would be viewed by PBBs as a desirable objective. By this one action alone, PBBs could have a substantial impact on the foreclosure rate, helping keep more people in their homes and retaining the homes as part of a healthy local economy.

FDIC is in a position to facilitate that goal. One way is for the agency to change accounting rules to reflect the fact that profits and losses have different consequences for PBBs as non-profit entities, as does the balance sheet reflecting the total value of the bank and its assets.

It does not matter to the PBB how valuable the bank is, provided that doesn't interfere with its ability to carry out its mandate to provide credit to its customers. FDIC could recognize that difference and allow for different ways to account for those ideas.

FURTHER BENEFIT TO FDIC

In revising these accounting rules, FDIC stands to realize an even bigger financial benefit. Currently the agency provides loan loss guarantees to the buyers of failed banks and its current obligations already extend to more than $80 billion.

With the approval and oversight of the FDIC, non-profit PBBs can account for these losses differently than for-profit banks, as previously described.

By combining these two concepts, it would be possible for the PBB, in its acquisition of a failed bank, to accommodate a loan portfolio containing loans that later prove defective, without negative consequence to the PBB.

This would allow the FDIC, as a consequence of "giving" the bank to the PBB, to offload the majority of its obligations in current loss-share agreements with buyers of banks, saving FDIC untold amounts of potential future obligations.

Nonetheless, the PBBs will still face certain expenses in dealing with loan failures or in renegotiating terms to keep loans alive. FDIC should still cover such expenses, but those would be a tiny fraction of the amount of the loan loss itself. By this arrangement, FDIC could save the huge amounts of money it would otherwise pay to buyers of the banks.

For this fourth option to succeed, FDIC must determine that working with PBBs is in the best interests of FDIC, the federal government and the country, as well as the states where the banks are located, their communities, customers and local economies.

For more information, contact Michael Sauvante, chairman of the CEED Development Program at michaels@ceedprogram.com, (650) 641-1246.

HOW COMMUNITIES CAN INITIATE ACTION

Communities could use an existing local non-profit organization (or quickly form one), or their local city or county government could take over a failed community bank.

For larger failed institutions spread over larger territory, it may be in the best interests of the banks' home state to directly take over such banks, rather than have them be acquired by out-of-state interests that would be inclined to expatriate the banks' resources.

In both cases, government organizations and/or non-profits can work with an organization like the CEED Program to form a PBB. We are in the process of setting up an operation to help both non-profits and governments to establish PBBs and rescue their failed banks.

[5] *http://www.fdic.gov/news/news/press/2009/pr09167.html*