Commentary: Reflections on FIRREA

Alvin C. Harrell, Oklahoma City University School of Law
Commentary:
Reflections on FIRREA

By Alvin C. Harrell *

This issue includes the first of a two part symposium entitled “Banking Law 1990.” Because of the enormity of the changes and challenges confronting the American financial system as we enter the decade of the 1990s, this symposium has grown from a single issue into two parts; part two will be featured in the next issue.

Although this symposium will encompass a wide variety of current banking law issues, there will be considerable focus on FIRREA and, to a somewhat lesser extent, the thrift industry. The impact of FIRREA and the future of the thrift industry loom as matters of great importance and at the same time areas of perplexing uncertainty as we begin the final decade of the twentieth century. Moreover, as noted by Marcela Davison Aviles in this symposium, these issues have become intertwined with other matters of fundamental importance to the development of our financial system. Clearly FIRREA is far more than just thrift industry legislation. Therefore, a few editorial observations and perhaps even some outright speculation about FIRREA and its impact on our financial system seem timely and appropriate as an introduction to this symposium.

It should be apparent by now to everyone that FIRREA did not “bail out” the thrift industry. As suggested by Steve Huber in this issue, the better question is whether FIRREA is helping to kill it. As noted by both Professor Huber and Lawrence Connell in this issue, FIRREA is just one of several developments that challenge the survival of the thrift industry as we know it. While this may serve to delight competing financial

(Continued on Page 114)

* Professor Harrell is Editor of the Quarterly Report and associated with a small Oklahoma City thrift.

The Quarterly Report is published four times a year. Please address all correspondence concerning editorial content to Professor Alvin C. Harrell, Editor, Consumer Finance Law Quarterly Report, The Oklahoma City University School of Law, 2501 N. Blackwelder, Oklahoma City, Oklahoma 73106.
other provision of state or federal law. Any contracts for such purchases between the state entities and the RTC or FDIC will be effective without any further approval, assignment or consent. The state housing finance authorities and nonprofit entities must invest income attributable to the purchased assets in financing or rehabilitating low- and moderate-income housing in the state or local geographic area they serve.292

FIRREA defines state housing finance authorities as public agencies, authorities or corporations which serve as an instrumentality of any state or any political subdivision of a state, and which function as a source of residential mortgage loan financing in that state. Nonprofit entities are defined as not-for-profit corporations chartered under state law that are exempt from federal taxes under section 501(c) of the Internal Revenue Code, if no part of the new earnings of the entity inures to the benefit of any member, founder, contributor or individual.293

XIV. Title XIV - Tax Provisions

FIRREA effectively eliminates the special tax rules which have governed the tax treatment of FSLIC-assisted acquisitions since 1981, and which were modified and extended to the FDIC in 1988. In general, those rules provided that:

- payments from the FSLIC or the FDIC were not included in the income of the recipient institution and such institution would not be required to reduce its basis in property by the amount of such assistance; however, certain assistance payments would result in reduction of other tax attributes (including net operating losses, interest deductions and built-in losses) equal to 50% of the amount of the financial assistance;

- certain FSLIC and FDIC assisted acquisitions involving a financially troubled financial institution qualified as tax-free reorganizations without regard to the continuity of shareholder interest requirement; and

- Internal Revenue Code section 382 limitations on the ability of an acquiring corporation to utilize the net operating losses, built-in losses, and excess credits of a corporation acquired in a tax-free reorganization, were relaxed in the case of a “G” reorganization.

FIRREA provides that financial assistance received by a troubled financial institution generally is treated as taxable and included in such institution’s income at the time the institution’s assets are sold or transferred in a taxable asset acquisition. In many cases, such income will be offset by the net operating losses and built-in losses of the institution and, thus, tax liability will not result from such financial assistance. The Treasury also is given regulatory authority to relieve the financially troubled financial institution from tax liability where such institution’s net operating losses and built-in losses do not offset completely the amount of financial assistance.

FIRREA requires the acquisition of a troubled financial institution to meet the continuity of shareholder interest requirement in order to qualify as a tax-free reorganization. It is not clear whether such an acquisition could be structured so as to meet this requirement. If, however, an acquisition of a troubled financial institution were to qualify as a tax-free reorganization, FIRREA requires that the Treasury deny deductions and other tax benefits, where such benefits are reimbursed by nontaxable financial assistance. In addition, the full force of the Internal Revenue Code section 382 limitations would apply to restrict the post-acquisition use of pre-acquisition net operating losses, built-in losses, and excess credits.

Commentary: Reflections on FIRREA

Continued From Page 73

services firms in the short term, thoughtful observers must surely have some concern at the ease with which society decided to discard this fundamental part of our financial system. There may be lessons here for all of us to ponder.

Your author must admit to being unprepared for the torrent of public hostility that was unleashed against the thrift industry as a result of the insolvency of the FSLIC. As noted in the last issue,2 this insolvency resulted at least as much from 40 years of public policy blunders and a major regional downturn in real estate prices as from any insider fraud or wrongdoing in the industry.3 Most of the thrift industry was obviously more victim than perpetrator. And surely the healthy thrifts cannot be blamed for the failure of a government deposit insurance system.

Yet the attention by the media quickly fostered a kind of lynch mob mentality among commentators. It seemed that TV newscasters and political pundits everywhere delighted in recounting tales of thrift high-flyers who crashed, typically followed by grim reminders of how much the whole thing is going to cost every man, woman, and child in America. Seldom if ever was there mention of what the thrift industry does for America, or of contributing factors such as government policies that mandated investment in fixed-rate mortgages and then served up volatile interest rates and a regional collapse of real estate values. That this change in public sentiment could be suffered so quickly by an industry known largely for its benevolence in supplying generations of Americans with low-cost 30

(Continued on Page 143)
and it can create new entities (Deposit Insurance National Banks - DINBs) and savings associations in order to assist in orderly liquidation. It can organize Bridge Banks to assume assets and liabilities of one or more failed institutions. The FDIC is also authorized to establish administrative procedures for the filing and payment of claims as well as expedited claim procedures for those who claim to suffer irreparable injury. Judicial review of the claims process is also provided. In addition, the FDIC is given certain extraordinary powers, intended to parallel those of a trustee under the Bankruptcy Code. Accordingly, the FDIC can repudiate any "burdensome" contract with specific statutory limits on the amounts and circumstances of any claim for compensatory damages as a result of such repudiation.

There are also specific rules governing the repudiation of leases, contracts for the sale of real property, service contracts and certain "qualified financial contracts," such as repossession and mortgage-backed securities. There are, however, limits on the FDIC's ability to avoid perfected security interests in assets which it acquires, unless there is evidence of intent to hinder or defraud by the holder of the security interest. In addition, the FDIC can enforce executory contracts.

The FIRREA provides no express set of preferences or priorities, but the FDIC may establish such by regulation.

There are numerous parallels between the approach that FDIC is expected to take under FIRREA as to claims of creditors, and the procedures available under the Bankruptcy Code. However, the procedures are far from identical and there will be a considerable amount of uncertainty in connection with creditor claims against insolvent banks for some time.

For borrowers who assert that they have "lender liability claims" against insolvent institutions, the FIRREA caries forward many of the obstacles discussed above. The Act continues the codification of the D'Oench Doctrine, using the language of section 1823(e). Thus, the law and lore that have developed in connection with D'Oench and section 1823(e) will be carried over under the FIRREA. In addition, the FDIC is given authority to request a temporary stay of any judicial action or proceeding to which the failed IDI is or becomes a party and federal courts must oblige this request.

---

**Commentary: Reflections on FIRREA**

Continued From Page 114

... year fixed-rate mortgages serves as a reminder of the volatility of public and political opinion. What will happen if the commercial banks and the FDIC need similar help?

Hopefully it will never come to that. But if the threats were largely the victims of national economic and regulatory policies, a regional economic cycle, and a failure of our system of federal deposit insurance, then our society has yet to address fundamental flaws in the banking system that may threaten that system again and again. And the treatment of the threats in 1989 does not provide much in the way of encouragement that future crises will be dealt with in a measured and thoughtful fashion.

FIRREA also raises obvious concerns regarding our system of housing finance and the related matter of access to consumer financial services. If FIRREA means the end of an expansive, independent thrift industry, who will fill the role of financing America's housing? Can federal housing programs provide an adequate substitute for the thousands of neighborhood thrifts that have provided the funding to create a nation of homeowners?

FIRREA seems to be based partly on the theory that housing finance can be provided by coercion. The Qualified Thrift Lender Test (described by Robert A. Wittie and Rebecca H. Laird in this issue) requires thrifts to focus on residential mortgage lending. But, as noted by Lawrence Connell, there are conflicting pressures in the form of Thrift Bulletin 13, which essentially prohibits a thrift from holding fixed rate mortgages in its portfolio. Unless a thrift operates as a mortgage broker (or limits itself to adjustable rate loans -- which remain unpopular in many areas and present special risks of their own) it will be very difficult to reconcile these conflicting requirements and, if every thrift becomes a broker, who will supply the funds?

This kind of onerous and conflicting requirements will surely encourage an exodus from the thrift industry (if any further encouragement is needed), ultimately depleting the ranks of mortgage lenders.

In its early years the thrift industry grew and prospered as a simple, low overhead business that served the needs of the small saver and the working class borrower unable to finance a house on reasonable terms elsewhere. These were the hallmarks of an unplugged thrift industry operating in a competitive environment, but after 40 years of federal legislation and regulation, culminating in FIRREA, all of that has changed.²

(Continued on Back Page)

---

5. Bank and credit unions have moved more heavily into real estate lending in recent years, and this may help fill the gap. But increasing real estate loan losses have prompted a move toward counter-trend away from bank mortgage lending. See, e.g., Shah, Structure Home Price Spikes in Both Countys, Courting Market Jitters, Wall St. J. (Dec. 2, 1989), at A1; Three Big Northeast Banks Plan to Raise Their Loan Loss Reserves Significantly, Wall St. J. (Dec. 21, 1989), at A10. Fortunately banks are authorized (and encouraged) to maintain diversified portfolios containing other types of loans and investments, a source of strength generally provided by low for thrifts since the 1930s (except for a brief period of deregulation during the 1980s). (Continued in next column)

6. It is also possible that certain securities will help fill the void, but again this requires that there be buyers willing to purchase and hold the securities. Traditionally thrifts have found it hard to sell home mortgage loans originated in this country, frequently selling over $10 billion per year. See, e.g., STARKINS & CROMWELL, WOODED REGULATION WENT WRONG 25-45, 51 (1983). That is a large gap for any substitute to fill.

VI. Summary and Conclusion

It is clear that, under U.C.C. subsection 9-403(2), continuation statements must be filed within six months before expiration of the five year effective period of the prior statement, regardless of when a continuation statement was filed. If a continuation statement is not filed in timely manner, the perfection lapses and the secured creditor’s only recourse is to file a new financing statement. In that event perfection will date from the time of the new filing.

32. See Carroll and Hartt, supra note 31.

There is an exception to this lapse rule at subsection 9-403(2), for insolvency proceedings. Unfortunately this exception has been misconstrued in cases like Banque Paribas and Nardulli,33 with the result that considerable uncertainty now exists regarding the application of this important subsection and the duties it imposes on secured parties.

33. Id.

Commentary: Reflections on FIRREA

Continued From Page 143

Without a viable, independent thrift industry, who will serve these needs? Regrettably, the modern answer is likely to be more regulation from Washington in an effort to force other financial institutions to serve these markets. Already there have been proposals to mandate “lifeline banking” and “truth in savings,” and FIRREA requires the regional Federal Home Loan Banks to institute affordable housing programs, as well as containing the seeds of other credit allocation measures.8 Ultimately the result is likely to be increased movement toward use of the financial system as a tool for social engineering. It will be interesting to see whether the public is as well served by this approach as it was by a deregulated thrift industry.

As a final observation one should note that these kinds of things often turn out differently than one expects; human affairs continue to be governed partly by the law of unintended consequences. In this instance the very stringency of the regulations and restrictions imposed on the thrift industry, which seem designed to promote an exodus from that industry, may so adversely affect the profitability of thrift operations and the marketability of the thrift charter as to impair the ability of owners (including the government) to sell or merge their institutions.

Clearly the inability of thrifts under FIRREA to diversify away from reliance on residential mortgage lending increases the risks associated with declining real estate values and regional economic downturns (which factors contributed so greatly to the FSLIC insolvency?); in this sense FIRREA is blatantly counter-productive and seems likely to set the stage for further thrift crises. Together with the risks to thrift owners posed by the new civil money and criminal penalties and other regulatory enforcement powers, and other FIRREA-related restrictions and complexities, FIRREA creates considerable disincentives for investment in a thrift institution. This, in turn, may make it more difficult for current owners to get out of the business, thereby inadvertently tending to preserve the status quo of a separate thrift industry.10

Separate, of course, does not mean equal, and the prospective health of the thrift industry is quite another matter. Still, and despite all of the publicity to the contrary, most of the thrifts in this country are solvent and are at least marginally profitable. While in many instances (and probably as an overall matter as well) FIRREA will impair that health, the chances are that many thrifts will survive FIRREA and will adapt somehow to the conflicting pressures of the new regulatory and competitive environment. Perhaps unable to sell or merge, many healthy thrifts probably will “tough it out,” with the result that a significant part of the thrift industry may survive (a sizeable achievement considering the forces that have battered this industry over the past two decades).

The new thrift industry will, of course, be sharply diminished, both in relation to its former self and its previous potential. In this respect it may be the nation, and not just the thrift industry, that suffers the ultimate loss.

[The views expressed in this commentary are solely those of the author and do not represent the Conference on Consumer Finance Law or the members of its Governing Committee.]

8. On the affordable housing programs, see FIRREA § 721, 12 U.S.C. § 1430(l)(1) & (q). See also FIRREA § 710, 12 U.S.C. § 163(n), requiring the Federal Home Loan Banks to issue an association’s community reinvestment rating as a condition for access to long term advances.

9. See, e.g., Huber, FIRREA: Requiem for the Thrift Industry, this symposium; Barth, Bartholomew, & Lebch, supra note 2.

10. Including, perhaps, its federally owned component.

11. See, e.g., Barth, Bartholomew, & Lebch, supra note 2; Barth, supra note 7.