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Implementation of FDICIA's Prompt Regulatory Action Provisions

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Committee on Banking, Housing, and
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This report summarizes the results of our self-initiated review of the implementation of the Federal Deposit Insurance Corporation Improvement Act of 1991's (FDICIA) Prompt Regulatory Action provisions, as amended. Our review focused on the Federal Reserve System's and the Office of the Comptroller of the Currency's efforts to implement the provisions and the impact of the provisions on federal oversight of depository institutions.

This report also discusses other initiatives, contained in FDICIA or self-initiated by the regulators, that are intended to improve the supervision and early identification of institutions with safety-and-soundness problems. No recommendations or matters for congressional consideration are presented in this report because it is too early to assess many of the more recent initiatives that the regulators are still implementing or testing to improve federal oversight of depository institutions.

We are sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, the Acting Director of the Office of Thrift Supervision, and the Secretary of the Treasury. We will also make copies available to others on request.

This report was prepared under the direction of Kane Wong, Assistant Director, Financial Institutions and Markets Issues. Other major contributors are listed in appendix VII. If you have any questions, please call me on (202) 512-8678.

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Executive Summary

Purpose

The thrift and banking crisis of the 1980s caused deposit insurance fund losses estimated at over $125 billion.[1] One of the many factors contributing to the size of the federal losses was weakness in federal regulatory oversight. Federal regulators were criticized for not taking prompt and forceful action to minimize or prevent losses to the insurance funds due to bank and thrift failures. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) was enacted to make fundamental changes in federal oversight of depository institutions. FDICIA's Prompt Regulatory Action provisions created two new sections in the Federal Deposit Insurance Act—sections 38 and 39—which mandate that regulators establish a two-part regulatory framework to improve safeguards for the deposit insurance funds. The first part focuses on capital levels of depository institutions, and the second part focuses on other measures of an institution's safety and soundness.

Since the passage of FDICIA, the financial condition of banks and thrifts has improved, and Congress has taken some actions and considered other actions to expand bank powers and activities. To keep Congress informed about changes in the safeguards of federal deposit insurance funds, this report assesses the progress and results of the federal regulators' implementation of FDICIA's Prompt Regulatory Action provisions, as amended. Specifically, this report assesses (1) the regulators' implementation of sections 38 and 39 of the Federal Deposit Insurance Act as of September 1996 and (2) the impact of the two sections on federal oversight of the banking industry.

Background

Section 38 of the Federal Deposit Insurance Act requires regulators to categorize depository institutions into five categories on the basis of their capital levels and to take increasingly severe supervisory actions as an institution's capital level deteriorates. The section requires regulators to define criteria for four of the five categories, which are identified as well-capitalized, adequately capitalized, undercapitalized, and significantly undercapitalized. It also requires the regulators to set the threshold for the fifth category, which is identified as critically undercapitalized, at no less than 2 percent of tangible equity capital. The section also establishes a system of mandatory supervisory actions that are to be triggered by an institution's capital levels. For example, regulators are required to obtain capital restoration plans from undercapitalized institutions, and the

[1]The $125 billion represents the estimated direct cost to the federal deposit insurance funds for closing or assisting in the merger of thrifts and banks that failed from 1980 to 1990. For additional information on the estimated cost of resolving the savings and loan crisis, see Financial Audit: Resolution Trust Corporation's 1995 and 1994 Financial Statements (GAO/AIMD-96-123, July 2, 1996).

regulators are required to close critically undercapitalized institutions within a 90-day period.[2] In addition, section 38 restricts depository institutions in the three lowest capital categories from engaging in certain activities that could increase the risk of losses to the federal deposit insurance funds.

Section 39 directs regulatory attention to the noncapital areas of an institution's activities as they pertain to safety and soundness. The section requires regulators to develop and implement safety-and-soundness standards in three areas: (1) operations and management; (2) asset quality, earnings, and stock valuation; and (3) compensation. Initially, the standards for asset quality and earnings were to be quantitative. Section 39 also initially required regulators to take specific regulatory actions against institutions not meeting prescribed safety-and-soundness standards, such as imposing growth restrictions or requiring the institution to increase its capital position. The Riegle Community Development and Regulatory Improvement Act of 1994 amended section 39 by eliminating the requirement for quantitative standards and allowing regulators greater discretion in setting standards as well as in determining whether to take action against institutions that fail to meet the standards. The amendments were enacted in response to concerns about the potential regulatory burden on banks and thrifts associated with section 39.

Four federal regulators oversee federally insured banks and thrifts. The Federal Reserve System (FRS) regulates state-chartered banks that are members of FRS (member banks) and all bank-holding companies; the Federal Deposit Insurance Corporation (FDIC) regulates state-chartered, nonmember banks; the Department of the Treasury's Office of the Comptroller of the Currency (OCC) regulates nationally chartered banks; and Treasury's Office of Thrift Supervision (OTS) regulates all federally insured thrifts, regardless of charter type.

GAO's review of the implementation and use of section 38 was confined to OCC and FRS. As part of this review, GAO analyzed the supervisory actions taken on a sample of 61 banks that were undercapitalized for section 38 purposes. This sample provided coverage of 68 percent of the OCC-regulated banks and 56 percent of the FRS-regulated banks that were undercapitalized during the period December 1992 through December 1994, according to financial data obtained from FDIC. GAO relied

[2]FDICIA allows an exception to the 90-day closure rule if both the primary regulator and the Federal Deposit Insurance Corporation concur and document why taking some other action would better achieve section 38's purpose, which is to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance funds.

on similar reviews of OTS and FDIC, which were performed by the regulators' respective Offices of Inspector General (OIG), to assess their implementation of section 38. The two OIGS did not assess the implementation of section 39 or the impact of sections 38 and 39 on federal oversight of the thrift and bank industries. In its review of section 39 implementation, GAO did not sample cases because, at the time of its review, the regulators had not exercised their section 39 powers.

Results in Brief

Regulators have taken the required steps to implement FDICIA's Prompt Regulatory Action provisions but have had to use the additional enforcement powers granted by the provisions against a relatively small number of depository institutions. The improved financial condition of banks and thrifts has allowed them to build their capital levels to the point where only a few institutions were considered undercapitalized according to section 38 standards. On average, less than 1 percent of all banks and thrifts were classified as undercapitalized between December 1992 and December 1995. For the 61 undercapitalized banks in GAO's sample, OCC and FRS generally took prescribed regulatory actions. For example, the two regulators closed or merged all but 2 of the 25 critically undercapitalized banks in GAO's sample within the required 90-day time frame. As of September 1996, regulators had not used their section 39 enforcement authority. The final two safety-and-soundness standards—asset quality and earnings—required to fully implement section 39 became effective on October 1, 1996. Regulators issued the other required safety-and-soundness standards (dealing with operations and management and compensation) in July 1995, and those standards became effective in August 1995.

As amended and implemented to date, the Prompt Regulatory Action provisions strengthen federal oversight to a degree. But the provisions may not fully address one significant weakness that existed in the 1980s as noted by GAO and others—i.e., the failure of regulators to take strong, forceful enforcement actions early enough to prevent or minimize losses to the deposit insurance funds.[3]

Effective regulatory use of section 38 standards and enforcement actions should help prevent capital-deficient depository institutions from engaging in certain risky practices and conditions that contributed to the losses suffered by the insurance funds in the 1980s. Nonetheless, most troubled

[3]Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991) and Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 15, 1991).

institutions experienced problems in other areas, such as asset quality and management, long before their capital became adversely affected. Section 39 was intended to increase the likelihood that regulators would take action to address safety-and-soundness problems before they result in the deterioration of capital. However, the guidelines and regulations issued to date by the regulators to implement section 39 do not (1) establish clear, objective criteria for what would be considered to be unsafe and unsound practices or conditions or (2) link the identification of such conditions to specific mandatory enforcement actions. Other provisions in FDICIA and initiatives recently announced by regulators should help in the early identification of depository institutions with safety-and-soundness problems. Ultimately, the success of these provisions and initiatives will be determined by the regulators' willingness to use their enforcement powers, including sections 38 and 39, early enough to prevent or minimize losses to the deposit insurance funds.

Principal Findings

Few Institutions Have Been Subject to Enforcement Actions Under Section 38

The overall financial condition of banks and thrifts has improved since the 1991 passage of FDICIA. Banks and thrifts reported record profit and capital levels from 1992 to 1995. As a result, the number of institutions considered undercapitalized according to section 38 capital standards has steadily declined since 1991. As of December 1995, a total of 29 federally insured banks and thrifts, or one-quarter of 1 percent of the total number (11,970), were considered undercapitalized according to section 38 capital standards.

OCC and FRS generally took the prescribed enforcement actions on the 61 undercapitalized banks in GAO's sample. The two regulators notified the banks of their undercapitalized status and corresponding restrictions. In addition, OCC and FRS typically obtained capital restoration plans from the banks, reviewed them within the prescribed 60-day time frame, and required modifications for some plans before granting approval. Moreover, the regulators generally closed those institutions that were rated critically undercapitalized within the 90-day time frame specified by section 38. The FDIC OIG reported similar conclusions regarding FDIC's compliance with section 38 provisions. As of September 1996, the Treasury OIG was in the process of finalizing its report on OTS' compliance with section 38 time frames for the receipt and review of capital restoration plans.

Neither FRS nor OCC has used the additional enforcement tools provided by section 38 to any great extent. These enforcement tools are the reclassification of a bank's capital category due to safety-and-soundness reasons and actions, known as directives, which are used to require banks to take specified corrective actions.

According to the regulators GAO interviewed, section 39 was not fully implemented by FDICIA's deadline of December 1, 1993, due to the (1) difficulty of developing standards acceptable to all four regulators, (2) concerns of regulators and depository institutions that the safety-and-soundness standards could increase regulatory burden—the cost of complying with federal regulations—on thrifts and banks, and (3) knowledge that Congress was considering amending the section 39 requirements to increase regulatory discretion in implementing and enforcing noncapital safety-and-soundness standards. The regulators obtained public comments on three separate occasions in their efforts to develop and issue the required safety-and-soundness standards. On August 27, 1996, the regulators issued the safety-and-soundness standards for asset quality and earnings, thereby allowing the full implementation of section 39 as of October 1, 1996.

Effectiveness of Sections 38 and 39 Is Yet to Be Determined

The capital standards implemented under section 38 have provided some additional protection against losses to the insurance funds. Section 38 gave depository institutions a strong incentive to increase capital levels to avoid the mandatory restrictions and supervisory actions associated with being undercapitalized. Section 38 also allows regulators to promptly close institutions when their tangible equity capital drops to 2 percent of their total assets, thereby preventing seriously troubled institutions from compounding their losses.[4] In addition, capital-based enforcement authority also serves as a useful supplement to regulators' traditional enforcement authority.

However, capital-based safeguards of insurance funds are inherently limited because capital does not typically show a decline until an institution has experienced substantial deterioration in other components

[4]Section 133 of FDICIA amended the Federal Deposit Insurance Act to establish 12 factors that regulators can use to close seriously troubled institutions to facilitate prompt regulatory action. One factor allows regulators to close critically undercapitalized institutions, which the regulators have defined as institutions with tangible equity capital ratios of 2 percent or less. Another factor allows regulators to close undercapitalized institutions that have no reasonable prospect of becoming adequately capitalized or that fail to (1) become adequately capitalized, (2) submit an acceptable capital restoration plan, or (3) implement a capital restoration plan submitted and accepted under section 38.

of its operations and finances. Deterioration in an institution's internal controls, asset quality, and earnings can occur years before capital is adversely affected. For example, of the 193 banks and thrifts designated by regulators as being problem institutions as of December 31, 1995, only 29 (or about 15 percent) were classified as undercapitalized for section 38 purposes. Consequently, by the time seriously troubled institutions become subject to section 38's mandatory restrictions and enforcement actions, there may be few options available to prevent or minimize losses to the deposit insurance funds.

Section 39, as amended, does not appear to significantly change the wide discretion that regulators have regarding the timing and severity of enforcement actions taken against troubled institutions. In 1991, GAO recommended that Congress and the regulators develop a "trip wire" system that would be based on clear, objective criteria as to what would constitute unsafe and unsound conditions or practices and what regulatory actions would result if institutions violated the specified criteria. In contrast, the guidelines and regulations developed to implement the amended section 39 consist of general statements of sound banking principles rather than specific measures of safety and soundness. Furthermore, the guidelines and regulations do not require regulators to take any specific action against institutions that fail to comply with the standards.

Nevertheless, FDICIA contains a number of accounting, corporate governance, and supervisory reforms that may result in greater management accountability from depository institutions and could help prevent safety-and-soundness problems from arising or, at least, allow their earlier identification. For example, FDICIA requires the management of large depository institutions to report annually on (1) the effectiveness of the institution's internal controls and (2) the institution's compliance with designated laws and regulations. Thus, regulators can use the results of these assessments to enhance their ability to identify institutions that have emerging or existing safety-and-soundness deficiencies. Regulators have also acted to improve their oversight by revising risk-based capital standards and their on-site examination procedures to better monitor and control excessive bank risk-taking (see apps. I and II). The success of these initiatives, coupled with the regulators' willingness to use their various enforcement authorities, including sections 38 and 39, will be instrumental in determining whether losses to the deposit insurance funds are prevented or minimized in any subsequent economic downturn.

Recommendations

GAO is not making any recommendations in this report.

Agency Comments and GAO's Evaluation

GAO requested comments on a draft of this report from the Office of the Comptroller of the Currency, the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. Their comments and GAO's responses are discussed at the end of chapter 3. The staffs of the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation also provided technical comments that were incorporated in this report where appropriate.

The Federal Reserve Board of Governors stated that it had no formal comments but that the report appeared to accurately describe the FRS' policies, procedures, and practices with respect to the implementation of FDICIA's Prompt Regulatory Action provisions, as amended.

Both the Office of the Comptroller of the Currency and the Office of Thrift Supervision agreed with GAO's conclusion that the implementation of section 38 has produced positive benefits to the regulatory oversight of depository institutions. In response to GAO's concern that the section 39 safety-and-soundness standards adopted by the regulators may not always result in early regulatory action, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision reiterated their endorsements of the regulatory discretion and flexibility provided by section 39.

GAO does not disagree that there is a need for some degree of regulatory discretion. Rather, GAO sees the issue as one of striking a proper balance between the need for sufficient regulatory discretion to deal with particular facts and circumstances and the need for certainty for the banking industry about what constitutes unsafe or unsound conditions and the supervisory actions that would result from those conditions. GAO notes that the implementation of FDICIA along with recent regulatory initiatives may help in the earlier detection of problems in federally insured institutions. These initiatives along with regulators' willingness to use their enforcement authorities—including sections 38 and 39—will be instrumental in preventing or minimizing potential losses to the deposit insurance funds and in determining whether the proper balance between discretion and certainty has been attained.

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Abbreviations

CDRI	Reigle Community Development and Regulatory Improvement Act of 1994
CRP	capital restoration plan
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FFIEC	Federal Financial Institutions Examination Council
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FSLIC	Federal Savings and Loan Insurance Corporation
FRS	Federal Reserve System
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
SAIF	Savings Association Insurance Fund

Introduction

In the 1980s and early 1990s, the solvency of the federal depository insurance funds was threatened when hundreds of thrifts[1] and banks failed. Taxpayers were forced to bailout the insurance fund for thrifts, and the insurance fund for banks had a negative balance for the first time in its history. This situation prompted concern and considerable debate about the need to reform federal deposit insurance and regulatory oversight. In response, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)[2] to, among other things, improve the supervision and examination of depository institutions and to protect the federal deposit insurance funds from further losses. Among its various provisions, FDICIA added two new sections to the Federal Deposit Insurance Act of 1950[3]—sections 38 and 39—referred to as the Prompt Regulatory Action provisions. The Prompt Regulatory Action provisions required federal regulators to institute a two-part system of regulatory actions that would be triggered when an institution fails to meet minimum capital levels or safety-and-soundness standards. Enactment of this two-part system was intended to increase the likelihood that regulators would respond promptly and forcefully to prevent or minimize losses to the deposit insurance funds from failures.

Background

The Federal Deposit Insurance Corporation (FDIC), Federal Reserve System (FRS), and two agencies within the Department of the Treasury—the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS)—share responsibility for regulating and supervising federally insured banks and thrifts in the United States.[4] FDIC regulates state-chartered banks that are not members of FRS; FRS regulates state-chartered, member banks; OCC regulates nationally chartered banks; and OTS regulates all federally insured thrifts, regardless of charter type. The regulators carry out their oversight responsibilities primarily through monitoring data filed by institutions, conducting periodic on-site examinations, and taking actions to enforce federal safety-and-soundness laws and regulations.

[1]The term “thrifts” refers to savings and loan associations and savings banks.

[2]FDICIA, Public Law 102-242, was passed on December 19, 1991.

[3]The Federal Deposit Insurance Act of 1950 (P.L. 81-797) revised and consolidated earlier Federal Deposit Insurance Corporation (FDIC) legislation into one act and embodies the basic authority for the operation of FDIC.

[4]State regulatory agencies share responsibility with federal agencies for regulating federally insured banks and thrifts that are state chartered.

Problems of Thrifts and Banks From 1980 to 1990

From 1980 to 1990, record losses absorbed by the federal deposit insurance funds highlighted the need for a new approach in federal regulatory oversight. Sharply mounting thrift losses over the decade bankrupted the Federal Savings and Loan Insurance Corporation (FSLIC), which was the agency responsible for insuring thrifts until 1989, despite a doubling of premiums and a special $10.8 billion recapitalization program. During this period, a record 1,020 thrifts failed at a cost of about $100 billion to the deposit insurance funds for thrifts. Banks also failed at record rates. From 1980 to 1990, a total of 1,256 federally insured banks were closed or received FDIC financial assistance. Estimated losses to the bank insurance fund for resolving these banks was about $25 billion. These losses resulted in the bank insurance fund's incurring annual net losses in 1988, 1989, and 1990 that jeopardized the fund's solvency for the first time since FDIC's inception.

Industry analysts have recognized many factors as contributing to the high level of thrift failures from 1980 to 1990. For example, thrifts faced increased competition from nondepository institutions, such as money-market funds and mortgage banks, as well as periods of inflation, recession, and fluctuating interest rates during that period. High interest rates and increased competition for deposits during the decade also created a mismatch between interest revenues from the fixed rate mortgages that constituted the bulk of the thrift industry's assets and the cost of borrowing funds in the marketplace. Increased powers granted to thrifts in a period during which supervision did not keep pace has also been cited by some analysts, including us, as contributing to the problems of the industry.

Regulators and industry analysts have associated a number of factors with the problems of banks during the 1980s. First, banks suffered losses resulting from credit risk—risk of default on loans—in an environment of prolonged economic expansion and increasingly volatile interest rates. The decade began with crises in agricultural loans and loans to developing nations. Next, unrepaid energy loans took a toll and led to the downfall of several major banks, including Continental Illinois in Chicago and First RepublicBank in Texas. As the decade came to a close, highly leveraged transactions and the collapse of commercial real estate markets, in which banks had been heavy lenders, depleted the capital structures of some major East Coast and West Coast banks and led to their failures.

One factor we and others cited as contributing to the problems of both thrifts and banks during this period was excessive forbearance by federal

regulators. Regulators had wide discretion in choosing the severity and timing of enforcement actions that they took against depository institutions with unsafe and unsound practices. In addition, regulators had a common philosophy of trying to work informally and cooperatively with troubled institutions. In a 1991 report,[5] we found that this approach, in combination with regulators' wide discretion in the oversight of financial institutions, had resulted in enforcement actions that were neither timely nor forceful enough to (1) correct unsafe and unsound banking practices or (2) prevent or minimize losses to the insurance funds. Regulators themselves recognized that their supervisory practices in the 1980s failed to adequately control risky practices that led to the numerous thrift and bank failures.

Legislative Response to the Thrift and Bank Crisis of the 1980s

Congress passed two major laws to address the thrift and bank crisis of the 1980s. The first, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA),[6] was enacted primarily in response to the immediate problems surrounding FSLIC's bankruptcy and troubles in the thrift industry. FIRREA created a new regulator for the thrift industry, OTS, and a new insurance fund, the Savings Association Insurance Fund (SAIF), to replace the bankrupt FSLIC. In addition, FIRREA increased the enforcement authority of both bank and thrift regulators. For example, FIRREA expanded the circumstances under which regulators could assess civil money penalties and increased the maximum penalty to $1 million per day.[7] FIRREA also authorized FDIC to terminate a bank's or thrift's deposit insurance on the basis of unsafe and unsound conditions.

The second major piece of legislation, FDICIA, contains several provisions that were intended to collectively improve the supervision of federally insured depository institutions. Specifically, FDICIA requires a number of corporate governance and accounting reforms to (1) strengthen the corporate governance of depository institutions, (2) improve the financial reporting of depository institutions, and (3) help in the early identification of emerging safety-and-soundness problems in depository institutions. In addition, FDICIA contains provisions that were intended to improve how regulators supervise depository institutions.

[5] Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 15, 1991).

[6] FIRREA, Public Law 101-73, was effective on August 9, 1989.

[7] The $1 million per day civil money penalty established by FIRREA can be assessed against an insured institution or institution-affiliated party under the following conditions. The institution or party must "knowingly" (1) engage in unlawful conduct or unsafe and unsound practices or (2) breach a fiduciary duty. Furthermore, the institution or party must "knowingly or recklessly cause a substantial loss to the institution or a substantial pecuniary gain or other benefit" to the party.

Among the corporate governance and accounting reforms, FDICIA establishes generally accepted accounting principles as the standard for all reports and statements filed with the regulators. FDICIA also requires the management and auditors of depository institutions to annually report on their financial condition and management.[8] The report is to include management's assessment of (1) the effectiveness of the institution's internal controls and (2) the institution's compliance with designated laws and regulations. In addition, FDICIA requires the institution's external auditors to report separately on management's assertions.[9] Furthermore, FDICIA requires the institutions to have an independent audit committee composed of outside independent directors.

Among the supervision provisions, FDICIA requires regulators to perform annual on-site examinations of insured banks and thrifts (an 18-month cycle was allowed for qualified smaller institutions with assets of less than $100 million).[10] FDICIA's sections 131 and 132 added two new sections to the Federal Deposit Insurance Act (sections 38 and 39) that require the implementation of a "trip wire" approach to increase the likelihood that regulators will address the problems of troubled institutions at an early stage to prevent or minimize loss to the insurance funds.

Section 38 Provisions

Section 38 creates a capital-based framework for bank and thrift oversight that is based on the placement of financial institutions into one of five capital categories. Capital was made the centerpiece of the framework because it represents funds invested by an institution's owners, such as common and preferred stock, that can be used to absorb unexpected losses before the institution becomes insolvent. Thus, capital was seen as serving a vital role as a buffer between bank losses and the deposit insurance system. Although section 38 does not in any way limit regulators' ability to take additional supervisory action, it requires federal regulators to take specific actions against banks and thrifts that have

[8]FDICIA contains an exemption from the annual reporting requirement for small depository institutions, which it defined as those institutions with less than $150 million in total assets or a greater amount if established by FDIC in regulations. FDIC issued regulations on June 2, 1993, that exempt institutions with less than $500 million in total assets from the annual reporting requirement (see 58 Fed. Reg. 31335).

[9]Section 2301(a) of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 contained in Title II, Subtitle C, of the Omnibus Consolidated Appropriations Act for Fiscal Year 1997 (P.L. 104-208, Sept. 30, 1996) repealed the requirement that an institution's external auditors report on the institution's compliance with designated laws and regulations.

[10]Section 2221 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 allows regulators to increase the maximum size of institutions allowed to be examined on an 18-month cycle to a level of $250 million in total assets if regulators determine that the greater amount would be consistent with the principles of safety and soundness.

capital levels below minimum standards. The specified regulatory actions are made increasingly severe as an institution's capital drops to lower levels.

Section 38 requires regulators to establish criteria for classifying depository institutions into the following five capital categories: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The section does not place restrictions on institutions that meet or exceed the minimum capital standards—that is, those that are well- or adequately capitalized—other than prohibiting the institutions from paying dividends or management fees that would drop them into the undercapitalized category.[11]

A depository institution that fails to meet minimum capital levels faces several mandatory restrictions or actions under section 38. The mandatory actions are intended to ensure a swift regulatory response that would prevent further erosion of an institution's capital. Specifically, section 38 requires an undercapitalized institution to

- submit a capital restoration plan detailing, among other things, how the institution is going to become adequately capitalized;
- restrict its asset growth during any quarter so that its average total assets for the quarter do not exceed the preceding quarter's average total assets, unless certain conditions are met; and
- receive prior regulatory approval for acquisitions, branching, and new lines of business.

Section 38 allows regulators to take additional actions against an undercapitalized institution, if deemed necessary. It also requires regulators to closely monitor the institution's condition and its compliance with section 38's requirements.

Section 38 requires regulators to take more forceful corrective measures when institutions become significantly undercapitalized.[12] Regulators must take 1 or more of 10 specified actions, including (1) requiring the sale of

[11]Section 301 of FDICIA amended section 29 of the Federal Deposit Insurance Act to make a distinction between well-capitalized and adequately capitalized institutions regarding brokered deposits. Well-capitalized institutions can accept brokered deposits without restriction. Adequately capitalized institutions can accept brokered deposits if they receive a waiver from FDIC. Section 301 also imposes certain interest rate restrictions for brokered deposits accepted by institutions that are not well-capitalized.

[12]Section 38 requires regulators to treat undercapitalized institutions that fail to submit or implement a capital restoration plan as significantly undercapitalized.

equity or debt or, under certain circumstances, requiring institutions to be acquired by or merged with another institution; (2) restricting otherwise allowable transactions with affiliates; and (3) restricting the interest rates paid on deposits by the institution. Each of these three steps is to be mandatory unless the regulator determines that taking such steps would not further the purpose of section 38, which is to resolve the problems of insured depository institutions at the least possible long-term loss to the insurance fund. Other specific actions available to the regulators include

- imposing more stringent asset growth limitations than required for undercapitalized institutions or requiring the institution to reduce its total assets;
- requiring the institution, or its subsidiaries, to alter, reduce, or terminate an activity that the regulator determines poses excessive risk to the institution;
- improving management by (1) ordering a new election for the institution's board of directors, (2) dismissing directors or senior executive officers, and/or (3) requiring an institution to employ qualified senior executive officers;
- prohibiting the acceptance, including renewal and rollover, of deposits from correspondent banks;
- requiring prior approval for capital distributions from holding companies having control of the institution; and
- requiring divestiture by (1) the institution of any subsidiary that the regulator determines poses a significant risk to the institution, (2) the parent company of any nondepository affiliate that regulators determine poses a significant risk to the institution, and/or (3) any controlling company of the institution if the regulator determines that divestiture would improve the institution's financial condition and future prospects.

Regulators can also require any other action that they determine would better resolve the problems of the institution with the least possible long-term loss to the insurance funds. Finally, section 38 prohibits significantly undercapitalized institutions from paying bonuses to or increasing the compensation of senior executive officers without prior regulatory approval.

Section 38 requires more stringent action to be taken against critically undercapitalized institutions. After an institution becomes critically undercapitalized, regulators have a 90-day period in which they must either place the institution into receivership or conservatorship or take other action that would better prevent or minimize long-term losses to the

insurance fund.[13] In either case, regulators must obtain FDIC concurrence with their actions. Section 38 also prohibits critically undercapitalized depository institutions from doing any of the following without FDIC's prior written approval:

- entering into any material transaction (such as investments, expansions, acquisitions, and asset sales), other than in the usual course of business;
- extending credit for any highly leveraged transaction;
- amending the institution's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order;
- making any material change in accounting methods;
- engaging in any covered transaction;[14]
- paying excessive compensation or bonuses; or
- paying interest on new or renewed liabilities at a rate that would increase the institution's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest on insured deposits in the institution's normal market area.

In addition, section 38 prohibits a critically undercapitalized institution from making any payment of principal or interest on the institution's subordinated debt beginning 60 days after becoming critically undercapitalized.[15]

Finally, section 38 permits regulators to, in effect, downgrade an institution by one capital level if regulators determine that the institution is in an unsafe and unsound condition or that it is engaging in an unsafe

[13]Any determination to take other action in lieu of receivership or conservatorship for a critically undercapitalized institution is effective for no more than 90 days. The regulator is then required to place the institution into receivership (or conservatorship) or make a new determination to take other action. Each new determination is subject to the same 90-day restriction. If the institution is critically undercapitalized, on average, during the calendar quarter beginning 270 days after the date on which the institution first became critically undercapitalized, the regulator is required to appoint a receiver for the institution. Section 38 contains an exception to this requirement if, among other things, the regulator and chairperson of the FDIC Board of Directors both certify that the institution is viable and not expected to fail.

[14]The term "covered transactions" refers to the following transactions between a depository institution and its affiliates: (1) a loan or extension of credit to the affiliate; (2) a purchase of or an investment in securities issued by the affiliate; (3) a purchase of assets—including assets subject to an agreement to repurchase from the affiliate—except such purchase of real and personal property that may be specifically exempted by the Federal Reserve Board by order or regulation; (4) the acceptance of securities issued by the affiliate as security for a loan or extension of credit to any person or company; or (5) the issuance of a guarantee, acceptance, or letter of credit—including an endorsement or standby letter of credit—on behalf of an affiliate. See section 23A(b)(7) of the Federal Reserve Act, 12 U.S.C. section 371c(b)(7).

[15]An exception to the prohibition on making payments on subordinated debt can be made by FDIC on the basis of conditions specified in section 38(h)(2)(B).

and unsound practice. For example, regulators can treat an adequately capitalized institution as undercapitalized if the institution received a less than satisfactory rating in its most recent examination report for asset quality, management, earnings, or liquidity. This downgrading would then allow regulators to require the institution's compliance with those restrictions applicable to undercapitalized institutions, such as limits on the institution's growth. Thus, section 38 allows regulators to take enforcement actions against an institution that presents a danger to the insurance fund by virtue of a factor other than its capital level. In addition to the specific provisions of section 38, another section of FDICIA provides FDIC with the authority to appoint a conservator or receiver for undercapitalized institutions that meet certain criteria.[16]

Section 39 Provisions

To limit deposit insurance losses caused by factors other than inadequate capital, section 39 directs each regulator to establish standards defining safety and soundness in three overall areas: (1) operations and management; (2) asset quality, earnings, and stock valuation; and (3) compensation. Section 39 originally made the safety-and-soundness standards applicable to both insured depository institutions and their holding companies, but the reference to holding companies was deleted in 1994.

The section originally required regulators to prescribe safety-and-soundness standards through the use of regulations. For the operations and management standards, section 39 did not provide specific requirements other than requiring regulators to prescribe standards on internal controls, internal audit systems, loan documentation, credit underwriting, interest rate exposure, and asset growth. For asset quality, earnings, and—to the extent feasible—stock valuation, the section initially required regulators to establish quantitative standards. (See the next section for a discussion of amendments made to section 39's original provisions.) Under compensation standards, regulators were to prescribe, among other things, standards specifying when compensation, fees, or benefits to executive officers, employees, directors, or principal shareholders would be considered excessive or could lead to material financial loss.

[16]FDICIA's section 133 amended section 11(c)(5) of the Federal Deposit Insurance Act to add additional grounds for the appointment of a conservator or receiver for troubled institutions. Among the 12 factors listed, one factor provides for the appointment of a receiver or conservator for institutions that are undercapitalized under section 38 and that (1) have no reasonable prospect of becoming adequately capitalized, (2) fail to become adequately capitalized when required to do so by the regulator, (3) fail to submit an acceptable capital restoration plan within the required time frames, or (4) materially fail to implement a capital restoration plan submitted and accepted under section 38.

Section 39 initially contained a number of provisions concerning the failure to meet the regulators' prescribed safety-and-soundness standards. One key provision of the section directed regulators to require a corrective action plan from institutions or holding companies that fail to meet any of the standards. Such plans were to specify the steps an institution or a holding company was taking or intended to take to correct the deficiency. Section 39 directed the regulators to establish specific deadlines for submission and review of the plans. If an institution or a holding company failed to submit or implement the plan, regulators were mandated to issue an order requiring the institution or holding company to correct the deficiency and to take one or more of the following remedial actions as considered appropriate:

- restrict the institution's or holding company's asset growth,
- require the institution or holding company to increase its ratio of tangible equity to assets,
- restrict interest rates paid on deposits, and/or
- require the institution or holding company to take any other action that the regulator determines would prevent or minimize losses to the insurance fund.

Section 39 also initially required regulators to take at least one of the first three previously mentioned remedial actions against institutions that (1) fail to meet any of the operational and/or asset quality standards listed in FDICIA, (2) have not corrected the deficiency, and (3) either commenced operations or experienced a change in control within the preceding 24 months or experienced extraordinary growth during the prior 18 months of failing to meet the standards.

Riegle Community Development and Regulatory Improvement Act of 1994 Amended Section 39's Provisions

The Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI)[17] was passed on September 23, 1994, and contains more than 50 provisions that were intended to reduce bank regulatory burden and paperwork requirements. Among its provisions, CDRI amended some of section 39's requirements to provide regulators with greater flexibility and to respond to concerns that section 39 would subject depository institutions to undue "micromanagement" by the regulators. The CDRI amendments allow regulators to issue the standards in the form of guidelines instead of regulations. If guidelines are used, the amendments give the regulators the discretion to decide whether a corrective action plan will be required from institutions that are found not to be in compliance with the standards. Finally, the amendments eliminate the

[17]Public Law 103-325.

requirement that regulators issue quantitative standards for asset quality and earnings and exclude holding companies from the scope of the standards.

CDRI did not change section 39's original provisions regarding the content and review of any plan required as a result of noncompliance with section 39's safety-and-soundness standards. Thus, regulators still are required to issue regulations governing the contents of the plan, time frames for the submission and review of the plans, and enforcement actions applicable to the failure to submit or implement a required plan.[18]

Condition of the Bank and Thrift Industries Has Improved

Since the passage of FDICIA in 1991, the financial condition of the bank and thrift industries has improved substantially. As shown in table 1.1, the net income of banks more than doubled between 1991 and 1995, reaching a record high of $48.8 billion in 1995.

Table 1.1: Annual Net Income of Federally Insured Banks and Thrifts, 1991-95

Dollars in billions

	(Constant 1995 dollars)	
Year	Net income of banks	Net income of thrifts
1995	$48.8	$7.6
1994	45.7	6.6
1993	45.2	7.1
1992	34.4	7.2
1991	19.8	1.0

Source: FDIC-published statistics.

Table 1.1 also shows that the net income of thrifts grew dramatically in 1992 from the 1991 level, decreased slightly in 1993 and 1994, and grew to a record $7.6 billion in 1995. In the period from 1992 through 1995, the number of bank and thrift failures declined from their 1980 to 1990 levels. For example, 6 banks failed in 1995, compared with 169 bank failures in 1990.

The low number of bank failures in recent years has allowed the bank insurance fund to rebuild its reserve level. After falling to a record low of negative $7 billion in 1991, the fund grew to over $25 billion in 1995. The

[18]Under section 39, regulators are required to issue regulations establishing reasonable deadlines for the submission of the plan (generally not later than 30 days after the entity fails to meet a standard) and for acting on it (generally not later than 30 days after the plan is submitted).

recapitalization of the bank insurance fund allowed FDIC to reduce the deposit insurance assessment rate paid by commercial banks twice in the latter part of 1995. As a result, commercial banks are paying the lowest average assessment rate in history.

Despite the improved performance of the thrift industry, the thrift insurance fund remained undercapitalized as of December 1995. FDICIA required FDIC to increase the bank and thrift insurance funds' reserve balances to at least 1.25 percent of the estimated insured deposits of insured institutions within 15 years of enactment of a recapitalization schedule.[19] FDIC achieved this reserve ratio for the bank insurance fund on May 31, 1995. However, SAIF is not expected to achieve its required reserve ratio until 2002, according to FDIC. Thus, insurance fund premiums paid by thrifts remain significantly higher than those paid by commercial banks.

Objectives, Scope, and Methodology

The principal objective of this review was to assess the progress and results of the federal regulators' implementation of FDICIA's Prompt Regulatory Action provisions. Specifically, we assessed (1) the efforts of federal regulators to implement sections 38 and 39 and (2) the impact of sections 38 and 39 on federal oversight of the bank and thrift industries.

To assess the federal regulators' efforts to implement sections 38 and 39, we compared the legislative provisions with the implementing regulations and guidelines developed and issued by the regulators. In addition, we asked for and reviewed additional guidance developed by OCC and FRS. We concentrated our assessment on OCC and FRS because the FDIC and Treasury Offices of the Inspector General (OIG), respectively, had performed similar reviews of FDIC's and OTS' implementation of section 38. To the extent possible, we used the results of the FDIC OIG effort to compare and contrast with the results of our review of OCC's and FRS' implementation of section 38. We did not include the Treasury OIG's results because the OIG was in the process of finalizing its evaluation. However, the OIG reviews did not assess FDIC's or OTS' implementation of section 39.

We also assessed OCC's and FRS' implementation of section 38 by analyzing the supervisory actions used on the 61 banks that were undercapitalized (including those that were significantly and critically undercapitalized) for section 38 purposes. We identified the 61 banks using financial data (call

[19]This requirement was subsequently amended by the Resolution Trust Corporation Completion Act, Public Law 103-204. This amendment allows FDIC to extend the 15-year recapitalization schedule for SAIF if FDIC determines that the extension will, over time, maximize the amount of semiannual assessments received by SAIF, net of insurance losses incurred by the fund.

reports)[20] obtained from FDIC for the quarters ending December 1992 through December 1994. In the case of OCC, we looked at all of the 52 undercapitalized banks that were located in OCC's Western, Southwest, and Northeast districts. These data provided us with coverage of 68 percent of all OCC-regulated banks that were undercapitalized during that period. For FRS, we looked at all nine undercapitalized banks under the jurisdiction of FRS' Atlanta, Dallas, and San Francisco district banks. Doing so resulted in a coverage of 56 percent of all FRS-regulated banks that were undercapitalized during that period. While our results are not projectable to all undercapitalized banks under OCC's and FRS' jurisdiction, our results are representative of the OCC and FRS locations that we visited.

As part of our assessment of (1) OCC's and FRS' efforts to implement sections 38 and 39 and (2) the impact of the sections on regulatory oversight, we interviewed OCC and FRS officials in the previously mentioned locations as well as in Washington, D.C. We obtained the officials' views on the legislative intent underlying sections 38 and 39 and the evolution of the final regulations and guidelines. We also had discussions with the officials about regulatory actions, both under their traditional enforcement and section 38 authority, taken against the 61 banks that we reviewed.[21] Additionally, we interviewed FDIC and OTS officials to obtain information on the interagency process used to develop the safety-and-soundness standards required to implement section 39.

To assess the impact of sections 38 and 39 on the regulatory oversight of banks and thrifts, we used the 61 banks that we determined were undercapitalized for section 38 purposes to evaluate OCC's and FRS' use of their section 38 authority (reclassification and directives) versus the use of traditional enforcement tools. In addition, we reviewed OCC's and FRS' internal guidance and policies regarding the use of section 38 versus their other enforcement tools. We also obtained and analyzed information on the number of banks that the regulators had determined were undercapitalized for section 38 purposes versus the number of banks they

[20]Call reports are statements of a bank's financial condition and income that are submitted to federal regulators. Thrifts submit a Thrift Financial Report, which contains similar information to a call report. Both banks and thrifts prepare and submit the reports on a quarterly basis.

[21]Regulators have a variety of actions prescribed by law and regulations that they can take against depository institutions. Traditional enforcement actions include (1) formal written agreements between regulators and bankers; (2) orders to cease and desist unsafe practices and/or violations; (3) assessments of civil money penalties; and (4) orders of removal, prohibition, or suspension of individuals from bank operations. (See 18 U.S.C. 1818.) In addition, regulators can issue directives. Directives are orders issued by regulators to insured institutions that fail to satisfy minimum capital standards, which require the institutions to take one or more actions to achieve required minimum capital levels. (See 57 Fed. Reg. 44891, Sept. 29, 1992.)

had identified as being "problem" banks.[22] We analyzed various articles and economic literature issued on (1) the impact of sections 38 and 39 on the regulatory process and (2) the implications of a capital-based regulatory approach in general. Additionally, we used OIG and our prior report results and recommendations to assess the content of the implementing regulations and guidelines as well as the likely impact of section 38 on the regulatory process.

We did our work from November 1994 to September 1996 in accordance with generally accepted government auditing standards. We provided a draft of this report to the Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision for their review and comment. A summary of the agencies' comments and our evaluation are included at the end of chapter 3. The agencies' comment letters are reprinted in appendixes III to VI. Staff of OCC and FDIC also provided additional technical comments on the draft report, which were incorporated as appropriate.

[22]Federal regulators assign a composite rating to each financial institution on the basis of an evaluation of financial and operational criteria. The rating is based on a scale from 1 to 5 in ascending order of supervisory concern. Problem institutions are those with financial, operational, or managerial weaknesses that threaten the institutions' continued financial viability. Depending on the degree of risk and supervisory concern, the institutions are rated either "4" or "5."

Few Institutions Have Been Subject to Enforcement Actions Under Sections 38 and 39

Regulators have taken steps to implement FDICIA's Prompt Regulatory Action provisions. However, the financial condition of banks and thrifts has improved since the passage of FDICIA in 1991 because relatively few institutions have been considered undercapitalized under section 38 as of September 1996. Our review of a sample of 61 undercapitalized banks found that OCC and FRS have generally met section 38 requirements regarding the identification of undercapitalized institutions, the receipt and review of capital restoration plans, and the closure of critically undercapitalized institutions. Our finding was consistent with the FDIC OIG's conclusions regarding FDIC's implementation of section 38. All three regulators (OCC, FRS, and FDIC) had virtually no experience in using their section 38 reclassification authority and had used their section 38 authority to take enforcement actions on a relatively small number of institutions.

As of September 1996, none of the regulators had used section 39 enforcement powers. All but two of the safety-and-soundness standards required for the implementation of section 39 became effective in August 1995. The remaining two standards—asset quality and earnings—became effective on October 1, 1996, allowing for the full implementation of section 39. The regulators explained that they missed the December 1993 statutory deadline for the implementation of section 39 due to (1) the complication of developing standards on an interagency basis, (2) the concern of ensuring that the standards did not unnecessarily add to the existing regulatory burden of depository institutions, and (3) the knowledge that Congress was considering amending section 39's requirements governing the standards.

Few Financial Institutions Have Been Undercapitalized Under Section 38

Regulations issued by the four regulators to implement section 38 requirements are intended to ensure that prompt regulatory action is taken whenever an institution's capital condition poses a threat to federal deposit insurance funds. Banks and thrifts have increased their capital levels since the passage of FDICIA so that relatively few financial institutions have been subject to section 38 regulatory actions in the 3 years that the regulations were in effect. Between December 1992—the effective date of the regulations—and December 1995, the number and total assets of institutions that were undercapitalized had decreased from about 2 percent in 1992 to less than one-quarter of 1 percent of all banks and thrifts by 1995.

The regulators jointly developed the implementing regulations for section 38 and based the criteria for the five capital categories on international capital standards and section 38 provisions. The four regulators specifically based the benchmarks for an adequately capitalized institution on the Basle Committee[1] requirement, which stipulates that an adequately capitalized international bank must have at least 8 percent total risk-based capital and 4 percent tier 1 capital.[2] For the definition of a critically undercapitalized institution, the regulators adopted section 38's requirement of a tangible equity ratio of at least 2 percent of total assets. The regulators based the criteria for the remaining three capital categories on these two benchmarks.

As shown in table 2.1, three capital ratios are used to determine if an institution is well-capitalized, adequately capitalized, undercapitalized, or significantly undercapitalized. A well-capitalized or adequately capitalized institution must meet or exceed all three capital ratios for its capital category. To be deemed undercapitalized or significantly undercapitalized, an institution need only fall below one of the ratios listed for its capital category. Although not shown in the table, a fourth ratio—tangible equity—is used to categorize an institution as critically undercapitalized. Any institution that has a 2-percent or less tangible equity ratio is considered critically undercapitalized, regardless of its other capital ratios.

[1]The Basle Committee is made of representatives from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. The chief purpose of the committee has been "to close gaps in the supervisory net and to improve supervisory understanding and the quality of banking supervision worldwide." The committee issued its final version of capital standards for international banks on July 15, 1988, under the title International Convergence of Capital Measure and Capital Standards.

[2]The total risk-based capital ratio consists of the sum of tier 1 and tier 2 capital divided by risk-weighted assets. Tier 1 capital consists primarily of tangible equity capital—equity capital plus cumulative preferred stock (including related surplus)—minus all intangible assets, except for some amount of purchased mortgage servicing rights. Tier 2 capital includes subordinated debt, loan loss reserves (both subject to maximum limits), and certain other instruments. Risk-weighted assets are calculated using a risk weighing to each asset, on the basis of the asset's relative default risk. These weights range from 0 percent for assets, such as cash and U.S. Treasury securities, to 100 percent for most loans.

Table 2.1: Summary of Four Section 38 Capital Categories and Ratio Requirements

	Capital ratio		
Capital category	**Total risk-based**	**Tier 1 risk-based**	**Leverage**
Well-capitalized[a]	10 percent or more and	6 percent or more and	5 percent or more
Adequately capitalized	8 percent or more and	4 percent or more and	4 percent or more
Undercapitalized	Less than 8 percent or	Less than 4 percent or	Less than 4 percent[b]
Significantly undercapitalized	Less than 6 percent or	Less than 3 percent or	Less than 3 percent

Note: Only the tangible equity ratio is used to determine whether an institution is critically undercapitalized. Institutions with a tangible equity ratio of 2 percent or less are considered to be critically undercapitalized.

[a]An institution cannot be considered to be well-capitalized if it is subject to a formal regulatory enforcement action that requires the institution to meet and maintain a specific capital level.

[b]The leverage ratio can be as low as 3 percent if the institution has a regulator-assigned composite rating of 1. Regulators are to assign a composite rating of 1 only to institutions considered to be sound in almost every aspect of operations, condition, and performance.

Source: Interagency regulations issued on September 29, 1992 (57 Fed. Reg. 44866).

So far, relatively few financial institutions have been categorized as undercapitalized and, thus, subject to section 38 regulatory actions. This situation was due, in part, to the improved financial condition of the bank and thrift industries. The implementation of section 38 also provided institutions with strong incentives to increase their capital levels to avoid the mandatory restrictions and supervisory actions associated with being undercapitalized. As shown in table 2.2, the number of financial institutions whose reported financial data indicated undercapitalization, based on section 38 implementing regulations, steadily declined between December 1992 and December 1995. The beginning of the decline coincided with the December 1992 implementation of section 38.

Table 2.2: Federally Insured Banks and Thrifts by Section 38 Capital Category, Year-End 1992-95

	Federally insured banks and thrifts							
	December 1992		December 1993		December 1994		December 1995	
Capital category	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Well-capitalized	12,990	93.8	12,873	97.4	12,328	97.8	11,783	98.4
Adequately capitalized	609	4.4	275	2.1	224	1.8	158	1.3
Undercapitalized	109	0.8	32	0.2	27	0.2	21	0.2
Significantly undercapitalized	83	0.6	24	0.2	14	0.1	5	0.0
Critically undercapitalized	60	0.4	16	0.1	9	0.1	3	0.0
Total	**13,851**	**100.0**	**13,220**	**100.0**	**12,602**	**100.0**	**11,970**	**100.0**

Note: Percentages may not total 100 percent due to rounding.

Source: FDIC.

Data reported by financial institutions indicated that 252 banks and thrifts, or about 2 percent of those institutions, were undercapitalized in December 1992, including those that were significantly and critically undercapitalized. As of December 1995, only 29 banks and thrifts, or about one-quarter of 1 percent of all banks and thrifts, fell into the undercapitalized categories.

Regulators Complied With the Basic Requirements of Section 38

Our review of regulatory actions at 61 sample banks indicated that OCC and FRS complied with the basic requirements of section 38 and its implementing regulations. Specifically, OCC and FRS categorized the banks in accordance with section 38 criteria and notified undercapitalized banks of the restrictions and regulatory actions associated with their capital category. In addition, OCC and FRS typically obtained and reviewed the required capital restoration plans within the time frames specified by section 38. Moreover, the two regulators generally took action to close the critically undercapitalized banks as required by section 38. Both regulators had limited experience with issuing section 38 directives or using their reclassification authority. The FDIC OIG reported similar results regarding FDIC's implementation of section 38.

OCC and FRS Classified Banks in Accordance With Section 38 Requirements

OCC and FRS correctly identified and categorized the 61 sampled banks using criteria specified in section 38 legislation and implementing regulations. While primarily relying on call reports, they also used the on-site examination process to identify undercapitalized banks. The

regulators then sent notices to those banks to inform the banks of their undercapitalized status and the associated section 38 mandatory restrictions, requirements, and regulatory responses.

In the jurisdictions of the offices that we visited,[3] OCC and FRS identified a total of 61 banks as being undercapitalized at some point from December 1992 through December 1994. The two regulators identified 60 banks as undercapitalized on the basis of the call report data reported to the regulators on a quarterly basis. FRS identified an additional bank as being undercapitalized on the basis of the results of an on-site safety-and-soundness examination. Table 2.3 shows the distribution of the banks in our sample by regulator and section 38 capital category.

Table 2.3: Section 38 Capital Categories of the 61 Undercapitalized Banks We Reviewed

	Number of banks identified by:			
Capital category	**OCC**	**FRS**	**Total number of banks**	**Status of banks as of December 1995**
Undercapitalized	18	2	20	4 merged, 1 voluntarily liquidated, 5 remained problem banks,[a] 10 improved
Significantly undercapitalized	11	5	16	4 merged, 1 voluntarily liquidated, 6 remained problem banks,[a] 5 improved
Critically undercapitalized	23	2	25	18 failed, 1 merged, 1 remained a problem bank,[a] 5 improved
Total/Status	**52**	**9**	**61**	**18 failed, 9 merged, 2 voluntarily liquidated, 12 remained problem banks,[a] 20 improved**

[a]Problem banks have one or more of the following attributes: (1) the banks have a regulator-assigned composite rating of 4 or 5, (2) the banks are under a formal enforcement agreement because of safety-and-soundness problems, and/or (3) the banks continue to be undercapitalized according to section 38 implementing regulations.

Source: GAO analysis of OCC and FRS files.

OCC and FRS sent the required notices to the management of the 61 banks in our sample informing them of their banks' undercapitalized status. The notification letters advised the banks of the mandatory requirements and restrictions associated with their section 38 capital category. For significantly and critically undercapitalized banks, the notification letters also pointed out the additional mandatory and discretionary regulatory

[3]We visited the OCC and FRS offices located in San Francisco and Dallas. In addition, we performed work in OCC's New York/Boston office and FRS' Atlanta office.

responses or actions associated with their section 38 capital categorization.

Capital Restoration Plan Requirements Were Generally Met

OCC and FRS generally met section 38 requirements governing capital restoration plans (CRP). Section 38 requires banks to prepare a CRP within 45 days of becoming undercapitalized and allows regulators 60 days to review the CRP. For the 61 banks that we reviewed, OCC and FRS were generally successful in getting banks to submit the plans on time and in meeting the required time frames for reviewing and approving or rejecting the plans.

Section 38 provisions require that CRPs prepared by undercapitalized institutions contain certain elements. Specifically, the section requires that CRPs specify

- the steps that the institution will take to become adequately capitalized,
- the levels of capital the institution will attain during each year the plan will be in effect,
- how the institution will comply with the restrictions or requirements applicable to its undercapitalization capital category, and
- the types and levels of activities in which the institution will engage.

Section 38 prohibits regulators from accepting a CRP unless it (1) contains the previously mentioned required elements, (2) is based on realistic assumptions and is otherwise likely to succeed, and (3) would not appreciably increase the institution's riskiness. Holding companies are required to guarantee the institution's compliance with the CRP and to provide adequate assurance of performance.

Although the notification letters sent to the 61 undercapitalized banks in our review indicated that a CRP was required, only 44 banks submitted a CRP. Of the 17 banks that did not submit CRPs, 15 experienced conditions within the first few months of becoming undercapitalized that, according to the regulator, precluded the need for a CRP. Specifically, nine failed, two merged with other banks, one was voluntarily liquidated, and three became adequately capitalized.

OCC chose not to pursue obtaining CRPs from the remaining two banks. In one case, OCC deferred its enforcement efforts pending the results of an ongoing investigation by the Federal Bureau of Investigation and local enforcement authorities into potential criminal activity by the bank's

management. In the second case, OCC issued a section 38 directive instead of formally enforcing the requirement that the bank submit a CRP to achieve corrective action in a more timely fashion.

OCC and FRS were generally successful in getting the 44 institutions that submitted CRPs to meet the 45-day requirement. As shown in table 2.4, 10 banks exceeded the 45-day requirement, but most had submitted CRPs within 55 days.

Table 2.4: Sampled Institutions' Timeliness in Submitting Capital Restoration Plans to Regulators

	Number of CRPs submitted to:	
Time frame for the receipt of the CRP	**OCC**	**FRS**
Received in 45 days or less	26	7
Received between 46 and 55 days	4	2
Received after 55 days	4	0
Unable to determine[a]	1	0
Total	**35**	**9**

[a]We were unable to calculate the time frame for submission of one CRP because critical data were not available in OCC's files.

Source: GAO analysis of OCC and FRS files.

OCC and FRS were typically successful in meeting the 60-day time frame for reviewing the 44 CRPs submitted by the banks in our sample. As shown in table 2.5, the regulators met the 60-day requirement on all but one applicable case where data were available to make a determination.

Table 2.5: OCC's and FRS' Timeliness in Reviewing Capital Restoration Plans Submitted by Sampled Institutions

	Number of CRPs reviewed by:	
Time frame for the review of the CRP	OCC	FRS
Reviewed in 60 days or less	30	9
Reviewed in 75 days	1	0
Not applicable[a]	3	0
Unable to determine[b]	1	0
Total	**35**	**9**

[a]According to the regulators, the review of CRPs was "not applicable" for three banks because (1) one improved to the adequately capitalized level within 60 days of submitting its CRP, (2) another failed within 60 days of submitting a CRP, and (3) the last was undergoing a change in ownership that, if successful, would have resulted in the bank's becoming well- or adequately capitalized.

[b]We were unable to calculate the time frames for the review of one CRP due to the lack of available documentation in OCC's files.

Source: GAO analysis of OCC and FRS files.

Of the 44 CRPs submitted by the banks that we looked at, OCC and FRS rejected 30 of the CRPs as inadequate and required those banks to revise and resubmit them. The regulators used the criteria specified in section 38 legislation to determine whether a CRP was acceptable. Ultimately, the regulators approved 29 of the CRPs submitted by the undercapitalized banks that we reviewed. Of the 15 banks whose CRPs were not approved, 10 ultimately failed. One of the 15 banks merged with another bank, and the remaining 4 banks obtained enough capital to eliminate the need for a CRP.

OCC and FRS Closed Critically Undercapitalized Banks Within the Required Time Frame

As required by section 38, OCC and FRS have generally taken action to close critically undercapitalized banks within a specified time frame. Under section 38, regulators are required to close critically undercapitalized institutions within 90 days of the institutions' becoming critically undercapitalized unless the regulator and FDIC concur that other actions would better protect the insurance funds from losses.

As previously shown in table 2.3, there were 25 critically undercapitalized banks in our sample. OCC and FRS closed 17 of these banks because they were critically undercapitalized.[4] Fifteen of the 17 banks were closed within the prescribed 90-day period. In the case of the two banks that were closed after the 90-day deadline had expired, regulators approved the

[4]An additional bank ultimately failed, but this occurred after the bank had received a capital injection, which put it into the adequately capitalized category for section 38 purposes.

delay to allow FDIC more preparation time for the orderly closure of the banks. For the remaining 8 critically undercapitalized banks in our sample, 1 merged and the other 7 improved their capital position above the critically undercapitalized level before the end of the 90-day period.

Few Institutions Were Subject to Section 38 Enforcement Actions

From December 1992 to September 1996, OCC and FRS used their section 38 authority to initiate directives against 8 of the 61 banks in our sample. Section 38 requires regulators to take specific regulatory actions against significantly undercapitalized institutions and to make the use of these actions discretionary for other undercapitalized institutions. In those instances in which section 38 directives were used, both OCC and FRS complied with the governing requirements of section 38 legislation and implementing regulations.

As previously discussed in chapter 1, section 38 mandates regulators to take at least 1 of 10 specified actions against significantly undercapitalized institutions.[5] The section also provides regulators with discretionary authority to take any of the 10 specified actions that they consider appropriate against undercapitalized institutions.

OCC used directives against a relatively small number of the banks in our sample. Of the 52 OCC-regulated banks we reviewed, 16 were significantly undercapitalized at some time between December 1992 and December 1994, according to their call report data.[6] Thus, unless the status of the banks changed, OCC would have been expected to have initiated a directive against the 16 banks to take the enforcement actions mandated by section 38. However, OCC only initiated directives against five of these banks. Seven of the remaining 11 banks either failed, merged, or improved their capital status within 90 days of becoming significantly undercapitalized, thus eliminating the need for OCC to issue a directive. OCC officials told us that directives were not initiated against the remaining four significantly undercapitalized banks because they were already subject to formal enforcement actions that OCC believed were similar to

[5]Of the 10 specific actions authorized, FDICIA established the presumption that the regulator take the following three actions unless the regulator determines that the actions would not further the purpose of section 38: (1) require recapitalization through the sale of stocks or obligations or require that the institution be acquired by or combined with another institution, (2) restrict transactions with affiliates, and (3) restrict interest rates paid by the institution. These mandatory action requirements also apply to an undercapitalized institution that fails either to submit an acceptable CRP or implement one accepted by the regulator.

[6]The 16 OCC-regulated significantly undercapitalized banks that we looked at included 5 banks that subsequently became critically undercapitalized.

those that would be covered by directives. Thus, initiating a directive would have duplicated the existing, ongoing enforcement actions.

FRS initiated directives against three of the seven[7] FRS-regulated banks in our sample that were categorized as significantly undercapitalized at some point between December 1992 and December 1994.[8] According to FRS, the need for it to issue directives was precluded for three significantly undercapitalized banks because they improved their capital status, merged with another institution, or were voluntarily liquidated shortly after becoming significantly undercapitalized. FRS did not initiate a directive against the remaining significantly undercapitalized bank because the applicable corrective actions were already under way in connection with existing federal and state enforcement actions and in connection with the bank's CRP.

OCC and FRS Reclassified Two Banks

From December 1992 to September 1996, OCC and FRS used their reclassification authority in two instances. Section 38 authorizes bank regulators under certain circumstances to downgrade, or treat as if downgraded, an institution's capital category if (1) it is in an unsafe or unsound condition or (2) it is deemed by the regulator to be engaging in an unsafe or unsound practice. Reclassifying an institution to the next lower capital category allows regulators to subject the institution to more stringent restrictions and sanctions.[9]

According to OCC officials, OCC would use its section 38 reclassification authority only if its traditional enforcement actions had not been successful in correcting a bank's problems. OCC officials told us that they prefer to use their traditional enforcement authority for several reasons. One reason was the broader range of options that OCC's traditional enforcement actions provide both in the areas covered by the enforcement action as well as in the degree of severity of the action. Another reason that OCC prefers to use its traditional enforcement actions is the bilateral nature of these actions. According to OCC officials, traditional enforcement actions, such as a formal written agreement between the regulator and an

[7]The seven FRS-regulated significantly undercapitalized banks that we looked at included two banks that subsequently became critically undercapitalized.

[8]Of the three directives FRS initiated, one was never issued because the bank complied with all of the provisions contained in the Notice of Intent to Issue a Directive, and the directive was not needed. Section 38 implementing regulations require the regulator to notify the institution before issuing a directive to give the institution time to comment on the proposed action.

[9]Section 38 does not provide for regulators to reclassify or treat a significantly undercapitalized institution as critically undercapitalized.

institution, may achieve greater acceptance by the institution for taking corrective action than the unilateral nature of section 38 reclassifications and/or directives. However, OCC officials said that reclassification under section 38 can sometimes allow them to initiate certain actions faster (i.e., through directives) than would be possible using their traditional enforcement actions.

In the one case involving OCC reclassification, the agency reclassified a bank from adequately capitalized to undercapitalized because (1) OCC believed the bank was operating in an unsafe and unsound condition that would impair its capital levels and (2) the bank had not complied with earlier OCC enforcement actions. The reclassification allowed OCC to initiate a directive that, among other requirements, mandated the dismissal of a senior bank official and a director who OCC believed were responsible for the bank's deteriorated condition. Despite OCC's use of its reclassification authority and a section 38 directive, the bank's condition deteriorated further until it failed 8 months later.

FRS has an internal policy that requires all problem banks, which it defined as banks with a composite rating of 4 or 5, to be considered operating in an unsafe and unsound condition and, thus, candidates for reclassification. Between December 1992 and December 1994, 58 banks[10] had a FRS-assigned composite rating of 4 or 5. In its only use of its reclassification authority, FRS reclassified a well-capitalized bank to adequately capitalized because of continuous deterioration in the bank's asset quality, earnings, and liquidity. This bank's capital levels subsequently deteriorated to the point where it was considered significantly undercapitalized. The bank has since improved its capital to the well-capitalized category and is no longer considered to be a problem institution by FRS.

OIG Reported Similar Section 38 Compliance by FDIC

In September 1994, the FDIC OIG reported that FDIC had generally complied with the provisions of section 38 and its implementing regulations.[11] Table 2.6 compares the three regulators' implementation of specific section 38 provisions.

[10]The 58 banks reviewed exclude composite-rated 4 or 5 banks whose capital ratios indicated that they were already considered undercapitalized according to section 38 standards.

[11]Audit of FDIC's Implementation of the Prompt Corrective Action Provisions of FDICIA (Sept. 23, 1994).

Table 2.6: Comparison of the Implementation of Key Section 38 Provisions by Regulator

	(Percent)			
Regulator	CRPs received within 45 days	CRPs reviewed within 60 days	Institutions receiving directives[a]	Number of reclassifications
OCC[b]	75	86	10	1
FRS[b]	77	100	33	1
FDIC[c]	73	74	30	0

[a]The percentage is calculated on the basis of the total number of institutions reviewed by GAO or the OIG.

[b]Information is based on GAO's analysis of 52 OCC-regulated banks and 9 FRS-regulated banks as of February 1996.

[c]Information is based on the FDIC OIG's analysis of 43 FDIC-regulated banks as of July 1994.

Source: FDIC OIG and GAO.

Regulators Had Not Used Their Section 39 Enforcement Authority

As of September 1996, regulators had not used their section 39 enforcement authority against an institution. In July 1995, regulators issued final guidelines and regulations to implement parts of section 39. Specifically, the regulators issued standards governing operations and management and compensation. They also issued requirements for submission and review of compliance plans.[12] The regulators issued the remaining standards required for the full implementation of section 39—asset quality and earnings—in August 1996.[13]

FDICIA had established a deadline of December 1, 1993, for the implementation of section 39. Regulators said they were unable to meet that deadline because of (1) the difficulty of jointly developing the standards, (2) the concerns of regulators and financial institutions that the implementation of section 39 could increase existing regulatory burden for banks and thrifts, and (3) the knowledge that Congress was considering amending the section 39 requirements to provide regulators with greater flexibility and discretion in their implementation of the section.

[12]60 Fed. Reg. 35673 (July 10, 1995).

[13]61 Fed. Reg. 43948 (Aug. 27, 1996).

Interagency Process and Concerns About Regulatory Burden Complicated the Development of Required Standards

According to the regulators, developing and issuing safety-and-soundness standards was complicated by the interagency process and by concerns about the potential regulatory burden associated with the standards. Unlike the process for promulgating capital standards under section 38, which used the Basle Accord as a reference point, the regulators had no generally accepted standards to use as the basis for the safety-and-soundness standards. In addition, the regulators told us that the legislative history for section 39 did not provide specific guidance on the standards envisioned by Congress. Furthermore, the regulators wanted to ensure that the section 39 standards did not increase the bank and thrift industries' regulatory burden without a corresponding benefit to the federal deposit insurance funds and taxpayers.

OCC and FRS officials said that the lack of generally agreed upon standards for the areas covered by section 39 contributed to delays in developing and issuing the section's standards. They explained that regulators consider numerous variables in assessing an institution's safety and soundness. As a result, developing standards on an interagency basis for areas such as internal controls and interest rate exposure was difficult. According to the officials, the various regulators had different viewpoints as to how specific or general the standards should be.

On July 15, 1992, the regulators issued a joint solicitation of comments on the section 39 safety-and-soundness standards.[14] In soliciting the views of the banking industry on the form and content of the standards, the regulators said that they were concerned with "establishing unrealistic and overly burdensome standards that unnecessarily raise costs within the regulated community." The four regulators collectively received over 400 comment letters, primarily from banks and thrifts.[15] According to the regulators, the comments strongly favored adopting general standards, rather than specific standards, to avoid regulatory "micromanagement."

The regulators considered the public comments in developing the proposed standards that were published on November 18, 1993.[16] The regulators proposed standards for the following three areas required by section 39: (1) operations and management, (2) asset quality and earnings, and (3) compensation. According to the notice of proposed rulemaking,

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[14]57 Fed. Reg. 31336.

[15]The 400 comment letters received by the regulators included multiple copies of some of the comment letters that were sent to more than one regulator.

[16]58 Fed. Reg. 60802.

regulators proposed general standards, rather than detailed or quantitative standards, to "avoid dictating how institutions are to be managed and operated."

However, as required by section 39 before its amendment in 1994, the regulators proposed two quantitative standards—a maximum ratio of classified assets-to-capital[17] and a formula to determine minimum earnings sufficient to absorb losses without impairing capital. Section 39 also required the regulators to set, if feasible, a minimum ratio of market-to-book value for publicly traded shares of insured institutions as a third quantitative standard. The regulators determined that issuing such a standard was technically feasible, but they concluded that it was not a reasonable means of achieving the objectives of the Prompt Regulatory Action provisions. The regulators explained that an institution's stock value can be affected by factors that are not necessarily indicative of an institution's condition, such as the performance of the general stock market and industry conditions. As a result, the regulators believed that a market-to-book value ratio would not be an operationally reliable indicator of safety and soundness. Therefore, the regulators ultimately decided against proposing a market-to-book value ratio as a third quantitative standard.

The proposed regulations also described procedures for supervisory actions that were consistent with those contained in the section 39 legislation for institutions failing to comply with standards. Specifically, the proposed regulations required institutions to prepare and submit a compliance plan within 30 days of being notified by the regulator of their noncompliance. The plan was to include a description of the steps the institution intended to take to correct the deficiency. Regulators would then have 30 days to review the plan. In addition, the proposed regulations specified enforcement actions regulators would take if an institution failed to submit an acceptable compliance plan or failed to implement the plan.

The regulators collectively received 133 comment letters, primarily from financial institutions, in response to the November 18, 1993, notice of proposed rulemaking. According to the four regulators, those who commented generally found the agencies' proposed standards, including the two quantitative standards, acceptable. However, some of those who commented criticized the proposed quantitative standards as inflexible and overly simplistic.

[17]Classified assets are loans and other assets that are at risk to some degree. Such assets fail to meet acceptable credit standards and are reported separately in bank call reports and thrift financial reports.

Consideration of Legislative Amendments to Section 39 Contributed to Additional Delays in Its Implementation

OCC and FRS officials attributed further delays in implementing section 39 to their knowledge that in the period from late 1993 to mid-1994, Congress was considering legislation that would amend section 39's requirements. Congress was considering amending section 39 to reduce the administrative requirements for insured depository institutions consistent with safe-and-sound banking practices. After CDRI was passed in September 1994, regulators needed additional time to revise the standards they proposed in November 1993 to take advantage of the additional flexibility provided by the section 39 amendments.

On July 10, 1995, the regulators published final and proposed guidelines and regulations to implement section 39, as amended. The final guidelines covered

- operational and managerial standards, including internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, and asset growth, and
- compensation standards.[18]

The final guidelines were effective in August 1995. Along with the final guidelines, regulators proposed new standards for asset quality and earnings. The final standards for asset quality and earnings were issued on August 27, 1996, with an effective date of October 1, 1996.

The final standards contained in the guidelines are less prescriptive on the institutions than those proposed in November 1993. For example, under internal controls and information systems, the guidelines specified that the "institution should [in lieu of shall] have internal controls and information systems, that are appropriate to the size of the bank and the nature and scope of its activities." [Underscoring supplied.] In addition, the regulators used the additional flexibility provided by CDRI to eliminate the two previously proposed quantitative standards for classified assets and earnings. According to the regulators, the use of general rather than specific standards was supported by the overwhelming number of commenters responding to the regulators' request for comments on the section 39 safety-and-soundness standards. Moreover, the use of guidelines instead of regulations gives the regulators flexibility in deciding whether to require a compliance plan from an institution found to be in noncompliance with the standards.

[18]In these guidelines, the regulators did not establish stock valuation standards for publicly traded institutions because they believed such standards would not be appropriate given that institutions do not have direct control over the marketplace's evaluation of their stocks' value.

The regulators issued regulations addressing the (1) required content of compliance plans, (2) time frames governing the preparation and review of a plan, and (3) regulatory actions applicable to the failure to submit or comply with a plan. The compliance plan regulations were issued jointly on July 10, 1995, with the section 39 guidelines governing the operational, managerial, and compensation standards. Both the guidelines and regulations became effective in August 1995.

The Effectiveness of Sections 38 and 39 Is Yet to Be Determined

FDICIA's Prompt Regulatory Action provisions granted additional enforcement tools to regulators and provided more consistency in the treatment of capital-deficient institutions. However, sections 38 and 39, as implemented, raise questions about whether regulators will act early and forcefully enough to prevent or minimize losses to the insurance funds. Section 38 does not require regulators to take action until an institution's capital drops below the adequately capitalized level. However, depository institutions typically experience problems in other areas, such as asset quality and management, long before these problems result in impaired capital levels. Moreover, regulators have wide discretion governing the application of section 39 because the guidelines and regulations implementing section 39, as amended, do not (1) establish clear and specific definitions of unsound conditions and practices or (2) link such conditions or practices to specific mandatory regulatory actions.

Other initiatives that have been undertaken as a result of FDICIA, as well as the regulators' recognition of the need to be more proactive in preventing unsafe and unsound practices, may help increase the likelihood that sections 38 and 39 will be used to provide prompt and corrective regulatory action. FDICIA's corporate governance and accounting reform provisions were designed to improve management accountability and facilitate early warning of safety-and-soundness problems. In addition, FDICIA requires regulators to revise the risk-based capital standards to ensure that reported capital accurately reflected the institution's risk of operations. Regulators have also announced new initiatives to improve monitoring and control of bank risk-taking, but these initiatives have not been fully implemented or tested. The success of these initiatives, coupled with the regulators' willingness to use their various enforcement authorities, including sections 38 and 39, will be instrumental in determining whether losses to the insurance funds are prevented or minimized in the future.

Section 38 Appears to Have Produced Some Benefits

Available evidence suggests that the implementation of the section 38 capital standards between 1992 and 1995, along with other factors, has benefited the bank and thrift industries and may have helped improve federal oversight. Specifically, the section 38 standards (1) provide financial institutions with incentives to raise equity capital, (2) should help regulators prevent seriously troubled institutions from taking actions that could compound their losses, and (3) should help ensure more timely closure of near-insolvent institutions. In addition, regulatory officials have

stated that section 38 serves as an important supplemental enforcement tool.

According to the regulators and banking industry analysts, section 38 provides depository institutions with strong incentives to raise additional equity capital. These officials explained that financial institutions were concerned about the potential ramifications of becoming undercapitalized, and the institutions raised additional equity capital to avoid potential sanctions. Once the implementing regulations were issued, depository institutions had clear benchmarks as to the levels of capital they needed to achieve to avoid mandatory regulatory intervention. Since the implementation of section 38, thanks in part to record industry profits, the capital levels of banks and thrifts have reached their highest levels since the 1960s.

Another benefit of the section 38 capital standards is that they should help prevent certain practices and conditions that rapidly eroded the capital of troubled institutions from 1980 to 1990 and contributed to deposit insurance fund losses. For example, section 38 standards impose growth restrictions to prevent undercapitalized and significantly undercapitalized institutions from trying to "grow" their way out of financial difficulty. As a result, it should be more difficult for these institutions to rapidly expand their asset portfolios and increase potential insurance fund losses, as many thrifts did during the 1980s. Section 38 also requires regulators to prohibit undercapitalized institutions from depleting their remaining capital by paying dividends.

OCC and FRS officials told us that another benefit of section 38 is the mandatory closure rule for critically undercapitalized institutions. These officials explained that before the implementation of section 38, regulators typically waited until an institution had 0-percent equity capital before closing it as insolvent. The officials also said that under section 38, they now have a clear legal mandate for closing problem institutions at 2-percent tangible equity capital, which should provide the insurance funds with a greater cushion against losses.

Regulatory officials we contacted also said that section 38 serves as a useful supplement to their traditional enforcement authority. For example, OCC officials said that section 38 directives allow for the prompt removal of bank officials when the agency believes such officials are responsible for the bank's financial and operational deterioration. OCC officials said that

before FDICIA, removing such individuals took longer, sometimes up to several months.

Section 38's Capital-Based Regulatory Approach Has Inherent Limitations

Although the capital-based regulatory approach strengthens federal oversight in several ways, by itself it has significant limitations as a mechanism to provide early intervention to safeguard the insurance funds. Capital is a lagging indicator of a financial institution's deterioration. Troubled institutions may already have irreversible financial and operational problems that would inevitably result in substantial insurance fund losses by the time their capital deteriorates to the point where mandatory enforcement actions are triggered under section 38. In addition, troubled institutions often fail to report accurate information on their true financial conditions. As a result, many troubled institutions that have serious safety-and-soundness problems may not be subject to section 38 regulatory actions.

Capital Is a Lagging Indicator of Financial and Operational Deterioration

Capital has been a traditional focus for regulatory oversight because it is a reasonably obvious and accepted measure of financial health. However, our work over the years has shown that, although capital is an important focus for oversight, it does not typically begin to decline until an institution has experienced substantial deterioration in other components of its operations and finances.[1] It is not unusual for an institution's internal controls, asset quality, and earnings to deteriorate for months, or even years, before conditions require that capital be used to absorb losses. As a result, regulatory actions, such as requirements for capital restoration plans or growth limits, may have only marginal effects because of the extent of deterioration that may have already occurred.

Reported Capital Levels Do Not Always Accurately Reflect Institutions' Financial Troubles

Relating regulatory actions to capital alone has another inherent limitation in that reported capital levels do not always accurately reflect troubled institutions' actual financial conditions. Troubled institutions have little incentive to report the true level of problem assets or to establish adequate reserves for potential losses. As a result, some institutions' reported capital levels were often artificially high. The reporting of inaccurate capital levels was evident from 1980 to 1990 as many of the troubled institutions, which reported some level of capital before failing, ultimately generated substantial losses to the insurance fund. Thus, capital-driven regulatory responses would likely have had limited effectiveness since the

[1] Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991) and GAO/GGD-91-69.

institutions were already functionally insolvent. As illustrated by the following example, troubled institutions' reported capital levels can plummet rapidly in times of economic downturn.

Problems Experienced by Regulators in the 1980s With New England Banks

In the 1980s, many New England banks, with average equity capital ratio levels exceeding the regulatory minimum requirements then in existence, were engaged in aggressive high-risk commercial real estate lending. These banks frequently ignored basic risk diversification principles by committing a substantial percentage of their lending portfolios to construction, multifamily housing, and commercial real estate lending—in some cases as high as 50 percent.[2] This practice tied their future financial health to those industries.

When the New England economy fell into recession in the late 1980s and early 1990s, many of the poorly managed banks in the region experienced a deterioration in their asset quality, earnings, and liquidity well before their capital levels declined. For example, once regulators recognized the recession's effect on the Bank of New England[3] portfolios, examiners required the bank to adversely classify[4] an increasing number of loans—especially commercial real estate loans whose repayment was questionable due to the economic downturn. As the level of classified loans increased, the examiners required the Bank of New England to establish reserves for potential loan losses, which reduced the bank's earnings. Subsequently, the bank suffered continued earnings deterioration and had to use its capital to absorb those losses.

The Bank of New England's managers and regulators had few options for maintaining solvency and, ultimately, for minimizing insurance fund losses. The available options included reducing the institution's inventory of classified loans by selling assets, raising capital through public offerings, or selling the institution to a healthy buyer. The managers' and regulator's ability to carry out these strategies was constrained by the region's economic downturn, since few investors were willing to purchase the assets of problem banks or to inject new capital into them without some form of financial assistance from FDIC. Ultimately, the bank failed,

[2]Many banks in other parts of the country, including Texas and California, also had overconcentrated portfolios in commercial real estate and energy investments.

[3]The Bank of New England was one of the largest bank failures during the period from 1986 to 1994 both in terms of the size of the bank ($22.4 billion in total assets) and the loss to the insurance fund ($841 million).

[4]Adversely classified loans are put into one of three categories to reflect their risk classification: (1) substandard, where some loss is probable unless corrective actions are taken; (2) doubtful, where repayment in full is questionable; and (3) loss, where a complete write-off of the loan is expected.

resulting in a loss to the bank insurance fund of $841 million. Other failed banks in the New England area followed a similar pattern, resulting in substantial losses to the insurance fund.

Most Troubled Institutions Were Not Subject to Section 38 Capital Standards

Another reason that section 38, used alone, is a limited mechanism to protect deposit insurance funds, is that most troubled institutions do not fall into undercapitalized categories, including some that ultimately fail. Consequently, regulators overseeing even the most troubled institutions generally would not be compelled to initiate mandatory enforcement actions under section 38.

We reviewed data compiled by FDIC that showed that many severely troubled institutions in the period from December 1992 to December 1995 did not fall into section 38's undercapitalized categories. Therefore, these institutions were not subject to the section's mandatory enforcement actions. On a quarterly basis, FDIC reports on the number of "problem" institutions. These institutions have regulator-assigned composite ratings of 4 or 5 because they typically have severe asset quality, liquidity, and earnings problems that make them potential candidates for failure. These institutions are also typically subject to more intensive oversight, including more frequent examinations by regulators and more frequent required reporting by the institutions on their financial conditions.

As of December 31, 1995, 193 banks and thrifts were on FDIC's problem institution list. However, only 29 institutions were categorized as undercapitalized under section 38 criteria. We made similar comparisons for 1992 through 1995 and found that only 15 to 24 percent of the problem institutions were categorized as undercapitalized under section 38 criteria (see table 3.1).

Table 3.1: Number of Undercapitalized Institutions Versus Problem Institutions, December 1992 to December 1995

Year-ending	Number of undercapitalized institutions	Number of problem institutions	Undercapitalized institutions as a percentage of problem institutions
December 1995	29	193	15.0
December 1994	50	318	15.7
December 1993	72	572	12.6
December 1992	252	1,063	23.7

Source: GAO analysis of FDIC Quarterly Banking Profile Reports.

Moreover, a recent study assessed the effectiveness of the current section 38 capital standards in identifying problem institutions and mandating enforcement actions by applying the section 38 standards to the troubled banks of an earlier period.[5] The study concluded that the majority of banks that experienced financial problems between 1984 and 1989 would not have been subject to the capital-based enforcement actions of section 38, if they had been in effect. For example, the study found that 54 percent of the banks that failed within the subsequent 2 years would have been considered to be well- or adequately capitalized between 1984 and 1989. Thus, even if the section 38 standards had been in place in the 1980s, these troubled banks would not have been subject to section 38's mandatory restrictions and supervisory actions.

The study attributed the limitations that the current section 38 standards have in identifying troubled financial institutions to weaknesses in the risk-based capital ratio used by the regulators. Specifically, the study stated that the risk-based ratio does not (1) account for the fact that many banks do not adequately reserve for potential loan losses or (2) assign an adequate risk weight to cover the level of adversely classified assets that a bank may have on its books. Although the regulators are in the process of revising the risk-based capital standards, the revisions announced as of September 1996 do not address the two previously mentioned factors. The regulators' efforts to revise the risk-based capital standards are discussed later in this chapter and in appendix I.

Mechanics National Bank's Failure Illustrates Limitations of Capital Standards

The 1994 failure of one of the banks reviewed by the Treasury OIG, Mechanics National Bank of Paramount, California, illustrated some of the limitations of section 38 capital standards.[6] The Treasury OIG found that despite OCC's aggressive use of section 38 enforcement actions, OCC did not reverse the bank's decline or prevent material loss to the bank insurance fund. The bank's failure also demonstrated that severely troubled banks may not be subject to section 38's restrictions and mandatory enforcement actions for a substantial period.

[5] D.S. Jones and K.K. King, The Implementation of Prompt Corrective Action (Journal of Banking and Finance, June 1995).

[6] Office of Inspector General, U.S. Department of the Treasury, Material Loss Review Under FDIA: Mechanics National Bank of Paramount, California (Sept. 29, 1995). Under the Federal Deposit Insurance Act as amended by FDICIA section 38(k), the Inspectors General for the responsible regulatory agencies are required to issue reports on bank failures that cause "material losses" to the insurance fund. Among other requirements, these reports are to determine the cause of each bank's failure and to assess the regulator's oversight of that bank.

According to the Treasury OIG report, the Mechanics National Bank pursued an aggressive growth strategy between 1988 and 1991 that contributed substantially to its failure. The bank concentrated its loan portfolio in risky service station loans and speculative construction and development projects. Under a Small Business Administration lending program, the bank also developed a significant portfolio of loans that was poorly underwritten and inadequately documented. In 1990, a downturn in the California economy generated a substantial deterioration in the bank's loan portfolio. In 1991, OCC issued a cease-and-desist order against the bank that required substantial improvements in the bank's operations and financial condition. Despite the cease-and-desist order, the bank's asset quality and earnings continued to deteriorate over the next several years.

The Treasury OIG report said that when section 38 capital standards became effective in December 1992, the Mechanics National Bank had a ratio of classified assets-to-capital of about 309 percent and had experienced losses of $4.3 million during 1992. OCC had just completed an examination of the bank in December 1992, which concluded that the bank was likely to fail. At that time, despite apparent asset quality and earnings problems, the bank's capital had not deteriorated to the point where it was undercapitalized according to section 38 criteria. The bank's capital ratios fell within the adequately capitalized category. The bank continued to be categorized as adequately capitalized during the first and second quarters of 1993, despite its high levels of classified assets and mounting losses. In July 1993, OCC reclassified the bank to the undercapitalized level. On January 10, 1994, OCC notified the bank that it was critically undercapitalized because its total capital-to-asset ratio had fallen below 2 percent. The regulators closed the bank in April 1994.

Although the Treasury OIG report criticized OCC's supervision and enforcement activities for the period between 1988 and 1991,[7] the report found that the agency's use of section 38 enforcement authority during 1993 and 1994 was appropriate. For example, the OIG report highlighted OCC's use of its section 38 reclassification authority to remove two Mechanics National Bank officers who were thought to be largely responsible for the bank's problems. OCC also used its section 38 authority to close the bank on April 1, 1994, within 90 days of the notification of its critically undercapitalized status. Nevertheless, OCC's enforcement actions under section 38 were largely ineffective in minimizing the losses that

[7]For example, the Treasury OIG report found that OCC did not comprehensively examine the Mechanics National Bank between 1989 and 1990. The OIG report also stated that OCC failed to adequately enforce the cease-and-desist order that was signed in 1991 because the bank continued to make poorly underwritten loans.

were already embedded in the bank's loan portfolio before it fell to the undercapitalized level. The bank's estimated loss to the insurance fund of $37 million represented 22 percent of the bank's total assets of $167 million.

The Bank Insurance Fund Continues to Absorb Losses Despite the Implementation of Section 38

The impact of section 38's implementation on minimizing losses to the insurance funds is difficult to assess. Between 1985 and 1989, losses to the bank insurance fund ranged from approximately 12 to 23 percent of the assets of failed banks with a 5-year weighted average of about 16 percent. As we reported in 1991,[8] this high rate of losses indicated that regulators were not (1) taking forceful actions that effectively prevented dissipation of assets or (2) closing institutions when they still had some residual value.

There have been some signs of improvement since the 1985-to-1989 period as illustrated in table 3.2. During the first 2 full years that section 38 was in effect, 1993 and 1994, the rates of loss were 17 and 10 percent, respectively, for a weighted average of 15 percent. While these loss rates are still significant, it is too early to assess section 38's long-term effectiveness in reducing losses to the insurance funds compared with preceding years. However, it does suggest that the implementation of section 38 alone is likely to provide only limited assurance that bank failures will not have significant effects on the insurance funds.

[8]GAO/GGD-91-26.

Table 3.2: Number of Failed Banks and Losses Absorbed by the Bank Insurance Fund, 1985-94

		(Dollars in millions)		
Year	Number of failed banks	Total assets of failed banks	Estimated bank insurance fund loss	Percentage loss of total assets
1985	120	$8,735	$1,008	11.5
1986	145	7,663	1,725	22.5
1987	203	9,234	2,021	21.9
1988	221	52,620	6,872	13.1
1989	207	29,395	6,123	20.8
1990	169	15,705	2,813	17.9
1991	127	63,198	6,269	9.9
1992	122	45,447	3,960	8.7
1993	41	3,524	584	16.6
1994	13	1,392	139	10.0

Source: FDIC.

Section 39 Safety-And-Soundness Standards Do Little to Increase the Likelihood of Early Regulatory Action

As discussed in chapter 2, the full implementation of section 39 began on October 1, 1996. However, the guidelines and regulations developed by regulators to implement section 39 do little to reduce the degree of discretion regulators exercised from 1980 to 1990. In particular, the safety-and-soundness standards contained in the guidelines are general in nature and do not identify specific unsafe or unsound conditions and practices even though the regulators have already established measures that could have served as a basis for more specific requirements. Moreover, the guidelines and regulations do not require regulators to take corrective action against institutions that do not meet the standards for safety and soundness.

Unsafe and Unsound Conditions and Practices Are Not Specifically Defined

In two 1991 reports,[9] we recommended that Congress and regulators develop a formal, regulatory trip wire system that would require prompt and forceful regulatory action tied to specific unsafe banking practices. The trip wire system we envisioned would have been specific enough to provide clear guidance about what actions should be taken to address specified unsafe banking practices and when the actions should be taken. The intent was to increase the likelihood that regulators would take forceful action to stop risky practices before the capital of the bank begins to fall and it is too late to do much about the condition of the bank or

[9]GAO/GGD-91-26 and GAO/GGD-91-69.

insurance fund losses. The trip wire system was also to consist of objective criteria defining conditions that would trigger regulatory action.

In contrast, the safety-and-soundness standards, contained in the guidelines developed to implement section 39, as amended, consist of broad statements of sound banking principles that are subject to considerable interpretation by the regulators. For example, the standards for asset quality state that the institution should establish and maintain a system to identify problem assets and prevent deterioration of those assets in a manner commensurate with its size and the nature and scope of its operations. Specifically, the guidelines direct institutions to do the following:

- conduct periodic asset quality reviews to identify problem assets and estimate the inherent losses of those assets,
- compare problem asset totals to capital and establish reserves that are sufficient to absorb estimated losses,
- take appropriate corrective action to resolve problem assets,
- consider the size and potential risks of material asset concentrations, and
- provide periodic asset reports containing adequate information for management and the board of directors to assess the level of asset risk.

Although the asset quality standards identify general controls and processes the regulators expect institutions to have, the standards do not provide specific, measurable criteria of unsafe conditions or practices that would trigger mandatory enforcement actions. In our 1991 report on deposit insurance reform,[10] we suggested that the classified assets-to-capital ratio could serve as an objective criterion because the ratio is routinely used by bank examiners to identify deteriorating asset quality. For example, we reported that the regulators become increasingly concerned when a bank's classified assets-to-capital ratio increased to 50 percent or more. Similarly, during the interagency process used to develop the section 39 safety-and-soundness standards, FRS had proposed that the regulators take mandatory enforcement actions when a bank's classified assets-to-capital ratio reached 75 to 100 percent. However, the regulators decided not to include this requirement after CDRI provided them with the option of omitting quantifiable measures of unsafe and unsound conditions. Without such specific criteria, regulators will continue to exercise wide discretion in determining whether a depository institution's asset quality deterioration is at a point where enforcement actions are necessary.

[10]GAO/GGD-91-26.

Similarly, the section 39-based loan documentation standards do not establish specific criteria for regulators to use to assess an institution's safety and soundness. The regulators believed that general standards provide an acceptable gauge against which compliance can be measured, while at the same time allowing for differing approaches to loan documentation. However, this approach to loan documentation standards differs from the long-standing approach that the regulators have established in their examination manuals. These standards contain specific loan documentation requirements that examiners are to use in assessing the safety and soundness of depository institutions. For example, real-estate construction loan files are to include current financial statements, inspection reports, and written appraisals. Since the section 39 standards do not contain similar documentation requirements, we believe the standards are open to considerable interpretation and do little to limit the wide discretion regulators have in determining whether banks have adequate loan documentation practices.

Furthermore, the loan documentation standards do not provide or state a specific level of noncompliance at which enforcement actions will be required. Although it may be difficult to develop quantifiable criteria for making such enforcement decisions, there are various regulatory "rules of thumb" in place that we believe could serve as the basis for triggering mandatory actions. For example, in its 1988 report on the reasons why banks fail, OCC found that banks with loan documentation problems in 15 to 20 percent or more of their loan portfolios were typically operating in an unsafe and unsound manner.[11]

Regulators Have Discretion to Require Section 39 Compliance Plans, and Requirements Are Not Specific

As discussed earlier, CDRI amended the section 39 mandate that regulators require a depository institution to file a compliance plan if the institution is found not to be in compliance with the standards. The new provision allows regulators greater flexibility in deciding whether to impose such a requirement. In the July 10, 1995, Notice of Final Rulemaking, the four regulators (OCC, FRS, FDIC, and OTS) stated that they expect to require a compliance plan from any institution with deficiencies severe enough to threaten the safety and soundness of the institution. However, as discussed in the previous section, regulators have not developed quantifiable criteria or other specific guidance for measuring an institution's compliance with the section 39 safety-and-soundness standards. Therefore, it is not clear how regulators would determine

[11]OCC, Bank Failures: An Evaluation of the Factors Contributing to the Failures of National Banks (June 1988).

whether an institution's noncompliance with generally accepted management principles is "severe" enough to warrant regulatory action.

In addition, the implementing regulations do not provide any specific criteria for compliance plans beyond those contained in the section 39 legislation. The regulations merely state that compliance plans should identify steps that the institution is to take to correct the identified problems and the time by which the steps are to be taken. In contrast, section 38 and its implementing regulations establish more specific criteria for CRPS. For example, CRPS must specify capital levels that the institution expects to achieve for each year the plans are in effect. In addition, CRPS must show how the institution will comply with any restrictions on its activities under section 38 and the types of businesses and activities in which the institution will engage. Section 38 requires regulators to reject any CRP unless it contains such information, is based on realistic economic assumptions, and would not appreciably increase risk to the institutions. In the absence of similar criteria, there is less assurance that the compliance plans developed under section 39 will consistently result in the prompt remediation of deficiencies.

Various Ongoing Initiatives May Result in Improved Regulatory Oversight

FDICIA contained a number of reforms and provisions that were designed to complement sections 38 and 39. FDICIA's corporate governance and accounting reform provisions directed depository institutions to improve their corporate governance and the information they report to the regulators. FDICIA also required regulators to revise their risk-based capital standards to ensure that those standards take adequate account of interest rate risk, concentrations of credit, and nontraditional activities. In addition, regulators have stated that their oversight of depository institutions has improved, and they are in the process of modifying their examination approaches to emphasize the monitoring of risk-taking by depository institutions. However, we did not evaluate the effectiveness of these various initiatives because many had not been fully implemented or tested.

FDICIA's Corporate Governance Requirements Can Enhance Management Accountability and Regulatory Oversight

FDICIA placed a number of new requirements on depository institutions to improve their corporate governance and the information they provide to the regulators. As previously discussed, FDICIA requires all but small (total assets of less than $500 million) depository institutions to submit annual reports to the regulator on the institutions' financial conditions and management. The report is to include management's assessment of (1) the

effectiveness of the institution's internal controls and (2) the institution's compliance with the laws and regulations designated by the regulator. In addition, FDICIA required the institution's external auditors to report separately on these assertions made by management.[12] Furthermore, FDICIA requires depository institutions to have an independent audit committee composed of outside directors who are independent of institutional management.

As we reported in 1993,[13] these new requirements have the potential to significantly enhance the likelihood that regulators will identify emerging problems in banks and thrifts earlier. For example, regulators can use the result of an institution's management assessments and external auditor's reviews to identify those areas with the greatest risk exposure. This identification process should allow the regulators to improve the quality and efficiency of their examinations. While these FDICIA requirements may result in the early identification of troubled institutions, they do not ensure that regulators will take consistent supervisory actions to address safety-and-soundness problems before they adversely affect an institution's capital levels.

Regulators Are Revising Their Risk-Based Capital Standards

In response to FDICIA section 305 requirements, regulators have recently undertaken revisions of the risk-based capital standards that they use to implement provisions of section 38. Specifically, regulators have revised or are revising the risk-based capital standards to cover risks associated with concentrations of credit, nontraditional financial products, and interest rate movements.[14] As of September 1996, the revisions to the risk-based capital standards announced by the regulators will not change the capital ratios used for section 38 purposes. Instead, regulators plan to use the examination process to identify institutions that have excessive and poorly managed risk exposure, due to concentrations of credit, nontraditional products, or interest rate risk. Regulators said that they will require such

[12]Section 2301(a) of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 repealed the requirement that an institution's external auditors report on compliance with designated laws and regulations.

[13]Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 16, 1993).

[14]The term "concentrations of credit" refers to situations when an institution has a large portion of its loan portfolio involving one borrower, industry, location, collateral, or loan type. Nontraditional financial product risks are the risks associated with activities or products that have not customarily been part of the banking business but that begin to be conducted as a result of developments in, for example, technology or financial instruments. The term "interest rate movement" refers to the risk that changes in market interest rates will have an adverse effect on an institution's earnings and its underlying economic value.

institutions to hold greater levels of capital than those required of other institutions. See appendix I for a more detailed discussion of section 305's requirements and the regulators' planned revisions to risk-based capital standards.

Other Regulatory Initiatives May Improve Depository Institution Oversight

Regulators have stated that they have learned from their experiences in the 1980s and that their approach to depository institution oversight has changed. The regulators said that they have recognized the need to take proactive steps to prevent institutions from engaging in unsafe and unsound practices. For example, OCC, FRS, and FDIC are developing new examination procedures to better monitor and control bank risk-taking (see app. II). A July 1996 proposal to revise the rating system used by the regulators also reflects the increased emphasis on evaluating an institution's risk exposure and the quality of its risk management systems.[15]

Efforts by the regulators to improve federal oversight through examinations focused on risk management, along with the accounting and corporate governance provisions of FDICIA, could help provide early warning signals of potential safety-and-soundness problems. However, whether this potential for earlier detection will be translated into corrective action is subject to some question because the regulators still have a great deal of discretion under section 39, as amended. Although the section 38 capital standards appear to have played some role in strengthening the condition of the banks and thrifts, other factors have also contributed to this improvement, including lower interest rates and an improving economy. Despite the apparently sound financial condition of the bank and thrift industry, the possibility cannot be ruled out that the current strong performance of the bank and thrift industry is masking management problems or excessive risk-taking that is not being addressed by regulators. For example, the financial press reported in November 1995 and March 1996 that delinquent consumer loans, such as credit card loans, grew considerably during these years and that this growth was partially attributed to lower credit standards.[16] Whether the regulators are more successful in detecting risk management problems and then taking the

[15]61 Fed. Reg. 37472 (July 18, 1996).

[16]The regulators have indicated that they are closely monitoring delinquencies by loan type. For example, FDIC testified before the House Committee on Banking and Financial Services on September 12, 1996, that consumer lending did not pose a significant risk to the deposit insurance funds at this time and that it would continue to closely monitor industry trends in consumer loan delinquencies and consumer loan portfolios at individual institutions.

requisite corrective actions may not be fully known until another downturn in the economy affects the bank and thrift industry.

Conclusions

In 1991, Congress enacted FDICIA, in part, because of concerns that the exercise of regulatory discretion during the 1980s did not adequately protect the safety and soundness of the banking system or minimize insurance fund losses. FDICIA's Prompt Regulatory Action provisions were originally enacted to limit regulatory discretion in key areas and to mandate regulatory responses against financial institutions with safety-and-soundness problems. The implementation of section 38 has provided capital categories and mandated actions that regulators should take if banks or thrifts fall into specific categories. However, section 39, as amended, appears to leave regulatory discretion largely unchanged from what existed before the passage of FDICIA.

Sections 38 and 39 provide regulators with additional enforcement tools that they can use to obtain corrective action or close institutions with serious capital deficiencies and/or safety-and-soundness problems. These provisions include the enforcement tool that allows regulators to remove bank officials believed to be the cause of the institution's problems as well as other actions intended to stop the institution from engaging in risky practices. Moreover, section 38 appears to have encouraged institutions to raise additional equity capital and should help prevent capital-deficient institutions from compounding losses.

Despite such benefits, severely troubled institutions may not be subject to mandatory restrictions and supervisory actions under section 38 due to its reliance on capital as the basis for regulatory intervention. In addition, section 39 does not require regulators to take actions against poorly managed institutions that have not yet reached the point of capital deterioration. Legislative and regulatory changes have resulted in the guidelines' taking the form of broad statements of general banking principles rather than as specific measures of unsafe and unsound conditions. Furthermore, regulators have not established criteria for determining when a institution is in noncompliance with the guidelines.

The implementation of FDICIA's other provisions and various initiatives undertaken by the regulators to improve their examination process may help to increase the likelihood that regulators will take prompt and corrective regulatory action. FDICIA's accounting and supervisory reforms provide a structure to strengthen corporate governance and to facilitate

early warning of safety-and-soundness problems. In addition, regulators have stated that their approach to supervision has changed since the 1980s, and they are developing new examination procedures to be more proactive in monitoring and assessing bank risk-taking. However, we did not evaluate the effectiveness of these initiatives because many of them have not been fully implemented or tested. Therefore, at present, it is difficult to determine if these initiatives will result in the earlier detection of safety-and-soundness problems and, if so, whether regulators will take strong and forceful actions early enough to prevent or minimize future losses to the insurance funds due to failures.

Agency Comments and Our Evaluation

In its comments on our report, OCC agreed with our conclusion that sections 38 and 39 may not always result in prompt and corrective regulatory action. Nonetheless, OCC believes that FDICIA's combination of section 38 mandatory restrictions and the regulatory discretion retained under section 39 allows regulators to tailor their supervision to suit an institution and its particular problems.

The Federal Reserve Board of Governors stated that it had no formal comments but that the report appeared to accurately describe the Federal Reserve's policies, procedures, and practices with respect to the implementation of FDICIA's Prompt Regulatory Action provisions, as amended.

OTS stated that section 38 effectively encourages institutions to avoid becoming or remaining undercapitalized. OTS emphasized that the section 39 standards are untested, and it supported the flexibility built into section 39. OTS believes that existing discretionary supervisory and enforcement tools are adequate to deal with most safety-and-soundness issues, apart from capital.

FDIC also supported the discretionary and flexible nature of the section 39 safety-and-soundness standards. FDIC pointed out that the overwhelming number of comments that the regulators received on the section 39 standards were in favor of general rather than specific standards. FDIC stated that the section 39 standards adopted by the regulators minimize regulatory burden while recognizing that there is more than one way to operate in a safe-and-sound manner.

We do not disagree that there is a need for some degree of regulatory discretion. Rather, we see the issue as one of striking a proper balance

between the need for sufficient regulatory discretion to respond to circumstances at a particular institution and the need for certainty for the banking industry about what constitutes an unsafe or unsound condition and what supervisory actions would be expected to result from those conditions. The subjective nature of the standards continues the wide discretion that regulators had in the 1980s over the timing and severity of enforcement actions. Such discretion resulted in the regulators' not always taking strong actions early enough to address safety-and-soundness problems before they depleted an institution's capital. However, we note that the implementation of FDICIA along with various regulatory initiatives undertaken since the passage of FDICIA may help in the earlier detection of institutions with safety-and-soundness problems. These initiatives, along with the regulators' willingness to use their various enforcement authorities—including sections 38 and 39—to prevent or minimize potential losses to the deposit insurance funds, will be instrumental in determining whether the proper balance between discretion and certainty has been attained.

Revisions to Risk-Based Capital Standards

Section 305 of FDICIA requires regulators to review their risk-based capital standards biennially to facilitate section 38's ability to prevent or minimize insurance fund losses. The section also requires regulators to revise the risk-based capital standards to ensure that the standards take adequate account of interest rate risk, concentrations of credit risk, and the risks of nontraditional financial products. Regulators are required to revise the risk-based capital standards to reflect the actual performance and risk of loss on multifamily mortgages. Section 305 required regulators to issue regulations prescribing the new standards no later than June 19, 1993. In addition to the actions taken in response to section 305's requirements, regulators have revised their risk-based capital standards by adding a market risk component in conformance with a recent amendment to the Basle Committee's capital standards for international banks.[1]

Capital Standards for Credit Concentration and Nontraditional Product Risks

On December 15, 1994, regulators issued final rules on revised risk-based capital standards to ensure that the standards account for credit concentrations and nontraditional products risks.[2] Loan concentrations pose substantial risks to depository institutions because problems with one borrower, industry, location, collateral, or loan type could cause substantial asset quality deterioration. Nontraditional product risks are associated with activities that have not customarily been part of the banking business (e.g., sophisticated financial instruments, such as derivatives).

In the course of developing the final rule on credit concentrations, regulators concluded that there is no generally accepted approach to identifying and quantifying the magnitude of risk associated with concentrations of credit. Therefore, regulators determined that it was not currently feasible to include a formula-based calculation to quantify the risk related to concentrations of credit. Instead, the final rule directs examiners to assess each bank's concentrations of credit and its ability to manage those concentrations. Under the final rule, institutions found to have excessive concentrations that are inadequately managed will be required to hold capital in excess of the regulatory minimums established by section 38.

[1]The Basle Committee amendment defined market risk as the risk of losses in on- and off-balance-sheet positions arising from movements in market prices. Specifically, the risks related to (1) interest rate-related instruments and equities in the trading book and (2) foreign exchange risk and commodities risk throughout the bank.

[2]59 Fed. Reg. 64561.

Like concentrations of credit, regulators did not issue quantitative formulas or standards for nontraditional products risk. Under the final rule, regulators will take into account the risks posed by nontraditional activities during the examination process. The regulators explained that the final rule recognized that the effect of a nontraditional activity on an institution's capital adequacy depends on the activity, the profile of the institution, and the institution's ability to monitor and control the risks arising from that activity. Regulators may require higher minimum capital ratios from those institutions found to have excessive risk due to nontraditional banking activities. The regulators stated that they will continue their efforts to incorporate nontraditional activities into risk-based capital.

Interest Rate Risk Capital Revisions

On August 2, 1995, regulators issued a final rule that amended their capital guidelines for interest rate risk.[3] Interest rate risk is the risk that changes to market interest rates will have an adverse effect on a bank's earnings and its underlying economic value. The final rule does not make explicit or quantitative changes to risk-based capital standards. Instead, the final rule directs examiners to consider, in their evaluation of a bank's capital adequacy, the exposure of the bank's capital and economic value to changes in interest rates.

The August 2, 1995, final rule did not adopt a measurement framework for assessing the level of an institution's interest rate exposure, nor did it specify a formula for determining the amount of capital that would be required. The intent of the regulators at that time was to implement an explicit minimum capital charge for interest rate risk at a future date, after the regulators and industry had gained more experience with a proposed supervisory measure that the agencies issued for comment in August 1995.[4]

At that time, regulators sought comments on their proposed framework for measuring and monitoring the level of interest rate risk at individual banks. The proposed system would, on a standardized basis, measure the risk of all banks not exempted from reporting additional information on their call reports.[5] In addition, regulators proposed encouraging banks to

[3]60 Fed. Reg. 39490.

[4]60 Fed. Reg. 39495.

[5]The only proposed exemption from the expanded reporting requirements was for banks with (1) total assets under $300 million, (2) composite supervisory ratings of 1 or 2, and (3) moderate or low holdings of assets with intermediate and long-term maturity or repricing characteristics.

report the results of their own internal, interest rate risk measurement systems on a voluntary and confidential basis. Examiners would then use the information from both sources in their assessments of the bank's interest rate risk management and capital adequacy. The results would also provide regulators with information on industry trends and patterns that would better inform both present and future supervisory efforts related to interest rate risk, such as the development of explicit minimum risk-based capital requirements for interest rate risk.

On June 26, 1996,[6] the regulators issued a joint policy statement on interest rate risk that did not incorporate the standardized measurement framework proposed by the regulators in August 1995. According to the regulators, the decision not to pursue a standardized measurement system reflected (1) concerns about the burden, accuracy, and complexity of a standardized measure and (2) the recognition that industry techniques for measuring interest rate risk were continuing to evolve. Instead, the June 1996 policy statement identified the key elements of sound interest rate risk management and described the prudent principles and practices for each of these elements. The regulators stated their intent to continue to place significant emphasis on the level of an institution's interest rate risk exposure and the quality of its risk management process when evaluating its capital adequacy.

Market Risk Measure

OCC, FRS, and FDIC have issued a final rule amending their risk-based capital standards to include market risk.[7] The final rule was intended to expand the existing credit-based focus of the regulators' risk-based capital standards. The regulators took this action in response to the Basle Committee's January 1996 amendment to its capital standards for international banks.[8] That amendment requires international banks to start incorporating market risk in their risk-based capital by the end of 1997.

The final rule issued by the regulators requires an institution that meets specific applicability criteria[9] to measure its exposure to market risk and hold capital in support of that exposure by January 1, 1998. Specifically, an

[6]61 Fed. Reg. 33166.

[7]61 Fed. Reg. 47357 (Sept. 6, 1996).

[8]Amendment to the Capital Accord to Incorporate Market Risks, Basle Committee on Banking Supervision, January 1996.

[9]Any bank or holding company whose trading activity equals 10 percent or more of its total assets, or whose trading activity equals $1 billion or more is required to adjust its risk-based capital to account for market risk.

institution must adjust its risk-based capital ratio to take into account the general market risk of all positions located in its trading accounts and of foreign exchange and commodity positions whether they are on- or off-balance sheet. Additionally, the institution must account for the specific risk of debt and equity positions located in its trading account.

The final rule on market risk allows an institution to use its own internal models to measure its exposure to market risk. However, the institution is required to determine the capital charges for its specific risks using a standardized approach methodology specified by the regulators. The regulators will then use the adjusted risk-based capital ratio to determine the institution's capital category under section 38 as well as for other statutory and regulatory purposes.

New Examination Procedures and Rating System to Better Monitor Bank Risk-Taking

OCC, FRS, and FDIC have announced or were developing new bank examination policies and/or procedures to better monitor bank risk-taking. The primary objective of the new banking examination procedures was to identify potential areas of risk and concentrate regulatory resources on those areas with the greatest potential risk. As of September 1996, these initiatives had not been fully implemented. In addition, the Federal Financial Institutions Examination Council (FFIEC)[1] issued a proposal in July 1996 that would revise the supervisory rating system used by regulators to, among other things, reflect changes that have occurred in supervisory policies and procedures.

Risk-Based Examination Initiatives

As shown in table II.1, OCC's initiative requires its examiners to separate risk into nine categories, ranging from credit and interest rate risk to compliance and reputation risk. Although similar in content, FRS' risk-based examination approach divides bank risk into six categories. Under both approaches, examiners rate each bank in each risk category, as well as overall, and analyze how well each category is managed. The risk rating of each institution would supplement and not replace traditional examination approaches, which focus on assessing bank asset quality, capital adequacy, and profitability. OCC and FRS developed the new examination system, in part, to better respond to developments in the financial services industry over recent years. For example, the new examination system is intended to help OCC and FRS better monitor banks' use of complex derivative financial products.

[1]FFIEC is an interagency group of depository institution regulators (OCC, FDIC, FRS, OTS, and the National Credit Union Association) that was formed in 1979 to maintain uniform standards for the federal examination and supervision of federally insured depository institutions.

Table II.1: Risk Factors Used in OCC's and FRS' Risk-Based Examination Procedures

	Risk category used in regulators' examination procedures	
Risk category	**OCC**	**FRS**
Credit: risk that borrower will default	yes	yes
Liquidity: risk that bank will not meet its obligation without selling assets at below-market rates	yes	yes
Interest rate: risk from fluctuating interest rates	yes	no
Market: risk from shifts in interest rates and foreign exchange rates	no	yes
Price: risk from changing values in a securities portfolio	yes	no
Reputation: risk of bad publicity	yes	yes
Strategic: risk of making bad business decisions	yes	no
Operational: risk of trouble from regular business practices	no	yes
Transactions: risk from product delivery problems	yes	no
Foreign Exchange: risk from changing exchange rates	yes	no
Compliance (OCC)/Legal (FRS): risk of violating laws or regulations	yes	yes

Source: OCC and FRS.

According to a senior FDIC official, FDIC was also developing a new examination policy on assessing bank risks. He said that the policy is to be based largely on a current policy statement, issued by FDIC in March 1994, that provides guidance on examining and assessing the risks of financial derivatives. In addition, FDIC was examining the new risk-based examination procedures announced by OCC and FRS as possible models for FDIC's new examination policy on assessing bank risk. The official said he was not certain when the new examination policy would be issued.

Proposed Supervisory Rating System Revisions

On July 18, 1996, FFIEC requested comments on proposed revisions to the Uniform Financial Institutions Rating System, which is commonly referred to as the CAMEL (Capital, Asset, Management, Earnings, and Liquidity) rating system.[2] The proposed revisions reflected changes occurring in the financial services industry and in supervisory policies and procedures since the rating system was first adopted in 1979.

[2]61 Fed. Reg. 37472.

The proposed revisions included (1) the reformatting and clarification of the existing component rating descriptions; (2) the addition of a sixth rating component addressing sensitivity to market risks; (3) an increase in emphasis on the quality of risk management processes in each of the rating components, particularly in the management component; (4) the addition of language in composite rating definitions to parallel the proposed changes in component rating definitions; and (5) the explicit identification of the risk types that are to be considered in assigning component ratings. FFIEC established September 16, 1996, as the deadline for receiving comments on its proposal.

Comments From the Office of the Comptroller of the Currency

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

September 13, 1996

Mr. James L. Bothwell
Director, Financial Institutions and Markets Issues
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have reviewed your draft audit report titled BANK AND THRIFT REGULATION: Implementation of FDICIA's Prompt Regulatory Action Provisions. The report results from a self-initiated review of the efforts of the Federal Reserve System (FRS) and the Office of the Comptroller of the Currency (OCC) to implement certain provisions of the Federal Deposit Insurance Corporation Improvement Act (FDICIA). The provisions that amended Section 38 of the Federal Deposit Insurance Act require regulators to categorize depository institutions and take specified enforcement actions based on capital levels. Amendments to Section 39 require the regulators to implement safety and soundness standards in other areas. GAO found that few institutions have been subject to the required enforcement actions and that the legal provisions may not ensure prompt, corrective, regulatory action. We offer the following comments on the report's conclusions.

Few Institutions Subject to Enforcement Under Section 38

See pp. 27 and 28.

GAO concludes that the reason that few institutions have been subject to enforcement under Section 38 is that bank capital levels have increased as a result of record income levels. We believe increased capital levels may also be a response to implementation of prompt regulatory action by the regulators and not solely the result of increased income.

Capital levels have increased throughout the banking system. From the passage of FDICIA in December 1991 through the end of 1995, equity capital at commercial banks increased from $231.7 billion to $349.9 billion, an increase of 51 percent in only three years. During this same period, the aggregate commercial bank equity to total asset ratio increased from 6.75 percent to 8.11 percent, its highest level since the 1960s, while the risk-based capital ratio increased from 10.67 percent to 12.78 percent. In addition, from the fourth quarter of 1991 through the third quarter of 1994, the number of all undercapitalized banks decreased from 388 to 48, a decrease of 87.6 percent.

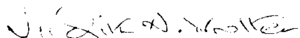
A number of empirical studies have concluded that increases in bank capital levels and capital asset ratios in recent years have been a response to regulatory changes such as risk-based capital standards. For example, a 1994 OCC Working Paper examined the impact of the risk-based capital standards on capital-asset ratios and found that banks meeting minimum regulatory capital standards increased their capital-asset ratios in response to implementation of the risk-based standards. Currently, our economics staff is continuing its research on the impact of capital standards on bank capital by examining how well-capitalized, adequately capitalized, and undercapitalized banks responded to the prompt regulatory action provisions of FDICIA.

Sections 38 and 39 May Not Ensure Prompt, Corrective, Regulatory Action

GAO concludes that Sections 38 and 39 may not ensure prompt, corrective, regulatory action. We agree. Nonetheless, prompt regulatory action is a valuable framework for addressing supervisory concerns at insured institutions, particularly with respect to capital adequacy. It provides very useful tools to regulators, and combines the use of certain mandatory supervisory safeguards and restrictions with the retention of discretion for regulators to tailor other relief to suit an institution and its particular problems. The combination of these two elements is key to the value of prompt regulatory action.

Thank you for the opportunity to review and comment on the report. Technical comments were provided to your evaluators separately.

Sincerely,



Judith A. Walter
Senior Deputy Comptroller for Administration

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Comments From the Federal Reserve Board

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

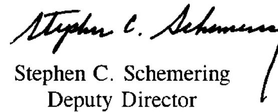
September 13, 1996

Mr. James L. Bothwell
Director
Financial Institutions and Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have read with interest the draft report, Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions. The report contains no recommendations to the Federal Reserve and therefore we have no formal comments. The report does appear consistent with the Federal Reserves' policies, procedures and practices with respect to the implementation of FDICIA's prompt corrective action provisions, as amended. Thank you for the opportunity to comment on this draft report.

Sincerely,



Stephen C. Schemering
Deputy Director

Comments From the Federal Deposit Insurance Corporation

FDIC

Federal Deposit Insurance Corporation
Washington, D. C. 20429

Office of the Director
Division of Supervision

October 11, 1996

Mr. James L. Bothwell, Director
Financial Institutions and Markets Issues
General Government Division
U. S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

Thank you for the opportunity to review and comment on your draft report entitled Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions.

FDIC staff has reviewed the report and has informally discussed our suggested revisions with a member of your staff. We have also reviewed a copy of the revised Executive Summary sent to us via facsimile on September 16, 1996. We note that, for the most part, the FDIC's suggested comments to the Executive Summary have been made and we have been told that our suggested edits to the text of the report also have been accepted. We appreciate the consideration of your staff and the opportunity to have an open dialogue on the report findings.

Now on p. 6.

There are two general points, however, that we would like to reiterate. One concerns the change made to the second paragraph on page 10 of the Executive Summary. The sentence, as revised, states

> "Section 38 capital standards also compel [the federal] regulators to promptly close near insolvent institutions while they still have some capital remaining, thereby preventing seriously troubled institutions from compounding their losses."

See pp. 6 and 19.

We believe that this sentence should be revised to more closely follow the statutory purpose of section 38. In addition, we suggest that this sentence be footnoted to indicate that there are 12 grounds for appointing a conservator or receiver under section 11(c)(5) of the Federal Deposit Insurance Act (FDI Act) as amended by section 133 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This would be consistent with the reference your staff has agreed to make in chapter 1.

The stated purpose of section 38 is to require the appropriate federal banking agency to resolve the problems of insured institutions at the least possible long-term loss to the deposit insurance fund. Section 11(c) of the FDI Act expands the grounds of the primary federal regulator for appointing a conservator or receiver and grants authority to the FDIC Board of Directors to appoint the FDIC as sole conservator or receiver in certain situations.

As a result, a troubled institution conceivably could meet one or more of the 12 grounds even though its tangible equity capital, under section 38 of the FDI Act and the prompt corrective action provisions under part 325 of the FDIC's regulations, is greater than the two percent "critically undercapitalized" threshold. Thus, we believe that the determination of when to recommend appointment of a conservator or receiver will be made on a case-by-case basis, and include a through analysis of the likelihood of whether the institution is expected to fail.

Now on p. 6.
See p. 37.

The other general point we would like to make concerns your comments regarding section 39 of the FDI Act entitled, "Standards for Safety and Soundness." As indicated on page 10 of the report, the agencies solicited public comment on three separate occasions. However, the report fails to indicate that the overwhelming number of commenters preferred general rather than specific standards. The commenters argued that imposing a rigid set of specific standards on an industry as diverse as banking would be overly complex and burdensome, and potentially could lead to excessive micro-management of the industry.

The approach recommended by commenters and ultimately adopted by the agencies includes sound operational and managerial standards that establish objectives that institutions can achieve by using methods tailored to their operations. This approach minimizes regulatory burden and recognizes that there is more than one way to operate in a safe and sound manner. By adopting the standards as guidelines, the agencies retain the authority to require an institution to submit an acceptable compliance plan as well as the flexibility to pursue other more effective action depending on the circumstances and severity of an institution's noncompliance.

We again thank the GAO for the opportunity to comment on the report and recommend that the above suggested comments be considered.

Sincerely,

Nicholas J. Ketcha Jr.
Director

Comments From the Office of Thrift Supervision

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6853

John F. Downey
Executive Director, Supervision

October 1, 1996

Mr. James L. Bothwell
Director, Financial Institutions
and Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have reviewed the draft report entitled "*Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions.*" Although the GAO review focused on the Federal Reserve System's and the Office of the Comptroller of the Currency's efforts to implement Prompt Regulatory Action (PCA) provisions, we appreciate the opportunity to review the draft document and have the following general comments:

Since PCA became effective in 1992, 114 thrift institutions have become undercapitalized for one or more quarters, and subject to the PCA provisions. While this is not a large number, we believe that it is big enough for us to judge PCA's effectiveness as a supervisory and enforcement tool.

OTS believes that PCA provides a powerful and effective incentive to cause boards of directors of thrift and bank institutions to act decisively, to avoid becoming undercapitalized; and if their institutions become undercapitalized, to promptly recapitalize. The minimum capital levels are clear for banks and thrifts, and the penalties for noncompliance are severe enough to cause boards of directors to act well before the PCA thresholds are crossed, and while the institutions still have economic value to support a sale of new capital, merger, or restructuring. Had the PCA capital requirements existed in the 1980s, we believe the cost of the thrift crisis would have been significantly lower, since supervisory restrictions on, and closure of, undercapitalized thrifts would have occurred earlier thereby reducing losses to the deposit insurer.

We believe that the results since PCA was implemented support our view of its effectiveness. Between December 1992 and June 1996, 114 thrift institutions became undercapitalized for more than one quarter. Of those, 102 were able to merge, restructure, recapitalize through sale of equity, or recapitalize through internally generated funds without government financial assistance. Banks had similar, successful results.

Mr. James Bothwell
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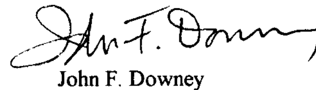
While we believe that PCA is effective in causing recapitalization, it is not a substitute for other supervisory and enforcement actions. PCA is tied to capital levels, and capital is a lagging indicator of financial problems. It is important that regulators continue to use other supervisory and enforcement tools, to stop unsafe and unsound practices before they result in losses, reduced capital levels, or failure.

The safety and soundness standards required by Section 39 were only recently adopted on an interagency basis. They are, therefore, still untested. OTS supports the flexibility built into this section, and believes that existing discretionary supervisory and enforcement tools are adequate to deal with most safety and soundness issues, apart from capital.

Thank you for providing the opportunity to comment on this draft document. I hope these comments are of assistance to you and your staff.

Sincerely,



John F. Downey

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