Office of Inspector General

July 15, 2005
Report No. 05-026

Capital Provision Requirements Established Under Supervisory Corrective Actions

AUDIT REPORT

Office of Audits

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Background and Purpose of Audit

As of December 2004, the FDIC supervised 278 financial institutions with a composite safety and soundness rating of 3, 4, or 5. In these cases, the FDIC's Division of Supervision and Consumer Protection (DSC) typically initiates supervisory corrective actions, including memoranda of understanding and cease and desist orders, to address weaknesses in the condition of these institutions. A capital provision is one of a variety of corrective measures that may be placed into a supervisory corrective action to improve an institution's financial structure and operations.

The audit objective was to determine whether DSC's process is adequate for determining capital provision requirements established under supervisory corrective actions for problem banks

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Results of Audit

Generally, DSC has been successful in using capital provisions as part of overall supervisory actions to improve the financial structure of problem banks, and its related processes are adequate. The 18 banks we selected for our sample had all received the lowest composite safety and soundness rating, but only 3 were poorly rated at the end of the period we reviewed. Almost all of the banks improved by at least one composite rating, and eight of the banks improved to a sound composite rating. Overall, supervisory personnel encouraged bank management to take corrective action and frequently obtained bank management commitment to increase and/or maintain designated capital levels. As a result, DSC was effective in persuading bank management to reduce and/or mitigate the level of risk to the bank and to the FDIC insurance funds. Further, we found that examiners were analyzing capital adequacy and the bank's adherence to supervisory corrective action capital provisions in accordance with DSC policies.

Nevertheless, our analyses showed that before the banks improved, the capital position at many banks weakened after they had complied with the capital provision requirements. The DSC Examination Manual contains eight evaluation factors on which to base the Capital Adequacy rating and states that the assessment should not be limited to those factors. Examiners addressed these eight factors in determining capital adequacy for examination purposes. However, we identified three other factors that could be considered in relation to capital provisions: prospective decline relative to Prompt Corrective Action (PCA) categories, length of time that banks remain a supervisory concern, and peer averages. In view of DSC's success with corrective actions, we are not recommending changes to the process for determining capital provision requirements, but we have provided our observations for DSC's consideration in developing future capital provisions.

We also found that supervisory personnel are not recommending capital provisions that encompass all of the PCA capital ratios. Specifically, the supervisory corrective actions usually did not include risk-based capital standards in the capital provisions. As a result, the established capital provisions do not ensure that a bank stays adequately capitalized as defined by the PCA capital categories.

Recommendation and Management Response

The report recommends that DSC improve supervisory guidance by addressing the use and consideration of both leverage and risk-based capital ratios in the formulation and recommendation of capital provisions.

FDIC management generally agreed with the findings of the audit report and agreed to implement the recommendation.

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Federal Deposit Insurance Corporation
801 17th Street NW, Washington, DC 20434

Office of Audits
Office of Inspector General

DATE: July 15, 2005

MEMORANDUM TO: Michael J. Zamorski, Director
Division of Supervision and Consumer Protection

FROM: Russell A. Rau [Electronically produced version; original signed by Russell A. Rau]
Assistant Inspector General for Audits

SUBJECT: *Capital Provision Requirements Established Under Supervisory Corrective Actions*
(Report No. 05-026)

This report presents the results of our audit of the Federal Deposit Insurance Corporation's (FDIC) process for establishing capital provision requirements within supervisory corrective actions. In all situations, bank management has primary responsibility for ensuring capital is sufficient and adequately maintained. Although statutory and regulatory thresholds for capital have been established, a financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution. The ability of bank management to identify, measure, monitor, and control these risks is important to minimize losses to the FDIC's insurance funds. To protect the financial integrity of the deposit insurance funds and maintain public confidence in the integrity of the banking system and in individual banks, the FDIC has regulatory and supervisory authority to conduct periodic on-site examinations of a bank's safety and soundness and compliance with laws and regulations. The examiner's assessment of capital adequacy is a key component in determining an institution's safety and soundness rating and in establishing the need for a capital provision requirement in supervisory corrective actions.

The objective of the audit was to determine whether the Division of Supervision and Consumer Protection's (DSC) process is adequate for determining capital provision requirements established under supervisory corrective actions for problem banks. Appendix I of this report discusses our objective, scope, and methodology in detail.

BACKGROUND

Capital is generally defined as the equity interest of an owner in a business and generally consists of the difference between assets and liabilities. In financial institutions, capital performs several very important functions. It absorbs losses, promotes public confidence, helps restrict excessive asset growth, and provides protection to investors and uninsured depositors. For all banks, but especially for problem banks, capital serves as a cushion to protect against the risk of loss to an institution, its shareholders, its depositors, and the insurance fund administered by the FDIC. As a result, the FDIC focuses attention on capital in examination and supervisory programs. In particular, capital adequacy is one of the component elements that must be evaluated in accordance with the Uniform Financial Institutions Rating System.[1] Examination coverage of capital adequacy is relied upon in establishing capital provisions in supervisory corrective actions.

As of December 2004, the FDIC supervised approximately 5,140 financial institutions with average total assets of $353 million and an average capital level of $38 million. Of those financial institutions, 278 were assigned a composite safety and soundness rating of 3, 4, or 5, with average total assets of $158 million and an average capital level of $18 million.

Regulatory Capital

The FDIC has issued several capital-based regulations. These regulations, in part, establish minimum capital standards and establish a framework for taking supervisory actions for institutions that are not adequately capitalized. The standards set forth the minimum acceptable capital requirements for fundamentally sound, well-managed institutions that have no material or significant weaknesses. Regulatory capital is further discussed in Appendix II.

Evaluation of Capital Adequacy

The evaluation and rating of capital adequacy is a judgmental process in which examiners take into account both subjective and objective variables. In performing an evaluation of capital adequacy, the *DSC Risk Management Manual of Examination Policies* (DSC Examination Manual) states:

> Banks are expected to meet any capital requirements properly established by its [their] primary State or Federal regulator, which exceed the minimum capital requirement set forth in the regulation. Once these minimum capital requirements are met, the evaluation of capital adequacy extends to factors that require a combination of analysis and judgment. Banks are too dissimilar to permit use of standards based on one or only a few criteria. Generally, a financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks.
>
> It is important to note that what is adequate capital for safety and soundness purposes may differ significantly from minimum leverage and risk-based standards and the "Well Capitalized" and "Adequately Capitalized" definitions that are used in the PCA [Prompt

[1] The Uniform Financial Institutions Rating System is based on a scale of 1 through 5. Banks with component capital adequacy ratings of 1 or 2 are considered to presently have adequate capital and are expected to continue to maintain adequate capital in future periods. A 3 rating should be assigned when the relationship of the capital structure to the various qualitative and quantitative factors comprising the analysis is adverse or is expected to become adverse in the relatively near future (12 to 24 months), even after giving weight to management as a mitigating factor. Banks rated 4 or 5 are clearly inadequately capitalized, the latter representing a situation of such gravity as to threaten viability and solvency.

> Corrective Action] regulations and certain other capital-based rules. The minimums set forth in the leverage and risk-based capital standards apply to sound, well-run institutions. Most banks do, and generally are expected to, maintain capital levels above the required minimums, based on the institution's particular risk profile. In all cases, institutions should maintain capital commensurate with the level and nature of risks to which they are exposed, including the volume and severity of adversely classified assets.

The DSC Examination Manual also notes that the capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of capital and the overall financial condition of the institution.
- The ability of management to address emerging needs for additional capital.
- The nature, trend, and volume of problem assets, and the adequacy of the allowance for loan and lease losses and other valuation reserves.
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.
- Risk exposure represented by off-balance sheet activities.
- The quality and strength of earnings and the reasonableness of dividends.
- Prospects and plans for growth as well as past experience in managing growth.
- Access to capital markets and other sources of capital, including support provided by a parent holding company.

Supervisory Corrective Actions

Informal[2] and formal[3] supervisory corrective actions address practices, conditions, or violations of law that could result in risk of loss or damage to an insured financial institution if continued. To mitigate loss or other damage to an institution, the FDIC identifies weaknesses and endeavors to secure correction of objectionable practices as soon as possible. The FDIC generally initiates formal or informal supervisory corrective action against institutions with a composite safety and

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[2] According to the *Formal and Informal Action Procedures Manual*, informal actions are voluntary commitments made by an insured financial institution's board of directors. Such actions are designed to correct noted safety and soundness deficiencies or ensure compliance with federal and state banking laws. Informal actions are not legally enforceable and are undisclosed to the public. Informal action is generally appropriate for institutions that receive a composite rating of 3 for safety and soundness. This rating indicates that an institution has weaknesses that, if left uncorrected, could cause the institution's condition to deteriorate. As an informal action, the FDIC can recommend that a bank adopt a Bank Board Resolution that commits itself to addressing specific noted deficiencies, or the FDIC can sign a Memorandum of Understanding with the bank.

[3] According to the *Formal and Informal Action Procedures Manual*, formal actions are notices or orders issued by the FDIC against insured financial institutions and/or individuals. The purpose of a formal action is to correct noted safety and soundness deficiencies, ensure compliance with federal and state banking laws, and/or enforce removal proceedings. Formal actions are legally enforceable and available to the public after issuance. A formal action is generally initiated against an institution with a composite rating of 4 or 5 for safety and soundness. The FDIC can issue the following formal actions: termination of federal deposit insurance; cease-and-desist action; removal, prohibition, and suspension actions; and civil money penalties. In addition, the FDIC can issue prompt corrective action directives to undercapitalized institutions.

soundness rating of 3, 4, or 5, unless specific circumstances warrant otherwise. Most corrective actions are initiated as a result of deficiencies noted during bank examinations. Deficiencies may also be identified in information extracted from quarterly Reports of Condition and Income filed by banks. Actions under Section 8 of the Federal Deposit Insurance (FDI) Act constitute formal adversarial proceedings against institutions or individuals. The burden of proving all charges rests with the FDIC. Since examiners may be called as witnesses at a formal hearing, examination guidance requires the Report of Examination to contain all pertinent facts in order to support each charge.

Table 1 identifies the number of formal Cease and Desist Orders (C&D) and informal Memoranda of Understanding (MOU) that were issued by the FDIC in 2003 and 2004 to address safety and soundness issues.

Table 1: Cease and Desist Orders and Memoranda of Understanding Issued

Year	Number of Cease and Desist Orders	Number of Memoranda of Understanding	Total
2003	35	127	162
2004	31	112	143
Total	**66**	**239**	**305**

Source: OIG Analysis of FDIC's 2004 Annual Report and On-line Resources.

The contents of supervisory corrective actions are tailored to each situation and address the specific problems of an individual institution. Formal actions attempt to halt or place corrective measures on violations of law and undesirable and objectionable practices that are regarded as unsafe and unsound. Generally, an unsafe or unsound practice embraces any action, or lack of action, that is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would result in an abnormal risk of loss or damage to an institution, its shareholders, its depositors, or the insurance fund administered by the FDIC. A capital provision[4] is one of a variety of corrective measures that may be placed into a supervisory corrective action to improve an institution's financial structure and operations.

RESULTS OF AUDIT

Generally, DSC has been successful in using capital provisions as part of overall supervisory actions to improve the financial structure of problem institutions, and its related processes are adequate. The 18 banks we selected for our sample had all received a composite safety and soundness rating of 5, but only 3 were rated 4 or 5 at the end of the period we reviewed. Almost all of the banks improved by at least one composite rating, and eight of the banks improved to a composite rating of 2. Overall, supervisory personnel encouraged bank management to take corrective action and frequently obtained bank management commitment to increase and/or maintain designated capital levels. As a result, DSC was effective in persuading bank

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[4] In accordance with the *Formal and Informal Action Procedures Manual*, provisions are specific corrective measures an institution or individual is required to take under a corrective action.

management to reduce and/or mitigate the level of risk to the bank and to the FDIC insurance funds. Further, we found that examiners were analyzing capital adequacy and the bank's adherence to supervisory corrective action capital provisions in accordance with DSC policies.

Nevertheless, our analyses showed that before the banks improved, the capital position at many banks weakened after they had complied with the capital provision requirements. In view of DSC's success with corrective actions, we are not recommending changes to the process for determining capital provision requirements, but we have provided our observations for DSC's consideration in developing future capital provisions (Finding A: *Decline in Capital Position after Compliance with Capital Provisions*).

We also found that supervisory personnel are not recommending capital provisions that encompass all of the Prompt Corrective Action (PCA) capital ratios. Specifically, the supervisory corrective actions usually did not include risk-based capital standards in the capital provisions. As a result, the established capital provisions do not ensure that a bank stays adequately capitalized as defined by the PCA capital categories. Supervisory guidance could be improved by addressing the use and consideration of both leverage and risk-based capital ratios in the formulation and recommendation of capital-level provisions (Finding B: *Capital Provisions and Prompt Corrective Action Capital Ratios*).

FINDINGS AND RECOMMENDATION

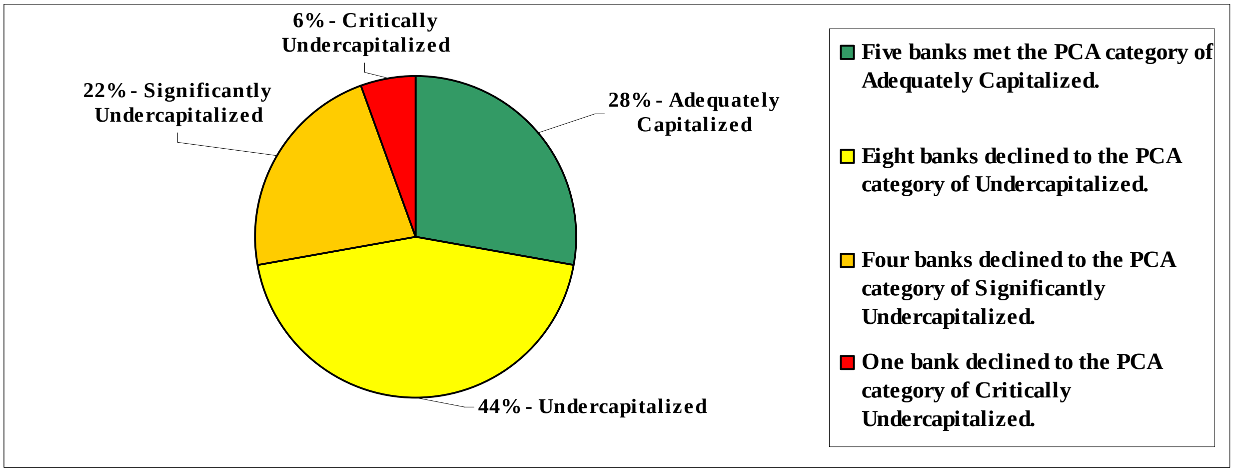
FINDING A: DECLINE IN CAPITAL POSITION AFTER COMPLIANCE WITH CAPITAL PROVISIONS

The capital position at many of the banks weakened after they had complied with the capital provision requirements. The DSC Examination Manual contains eight evaluation factors on which to base the rating of capital adequacy and states that the assessment should not be limited to those factors. Examiners addressed the eight factors in determining capital adequacy. However, we identified three other factors that could be considered in relation to developing future capital provisions: prospective decline relative to PCA categories, length of time that banks remain a supervisory concern, and peer averages.

Decline Relative to PCA Categories

As depicted in Appendix III, 8 (44 percent) of the 18 banks in our sample became undercapitalized subsequent to the issuance of a supervisory corrective action and the bank's achieving compliance with any outstanding capital provisions. This number increases to 12 (67 percent) of the 18 banks when including banks that had a supervisory corrective action without a capital provision or had a capital provision that did not address all of the PCA capital requirements. Bank management is ultimately responsible for achieving and maintaining an adequate level of capital. However, supervisory personnel are responsible for determining and setting an appropriate level of capital in supervisory corrective actions. Figure 1 depicts the levels of decline, by PCA capital category, since the issuance of the banks' supervisory corrective actions.

Figure 1: Decline in Capital Level -- by PCA Category

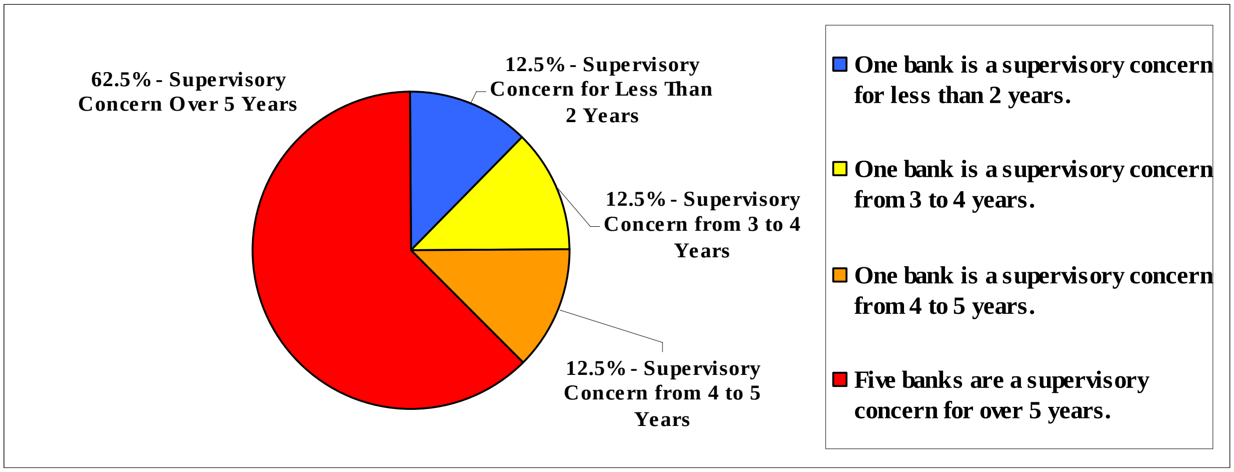


Source: OIG Analysis of Uniform Bank Performance Reports.

Length of Time a Bank Remains a Supervisory Concern

The established capital-level provisions are not always sufficient to ensure that problem banks do not remain a supervisory concern over a protracted period. Of the 18 banks in our sample, 2 (11 percent) banks have been designated as "inactive" through mergers into other banks, while 16 (89 percent) banks remained "active." For those 16 banks that are active, 8 (50 percent) banks have improved to the point of receiving a composite 2 rating. Conversely, of the remaining active banks, 8 (50 percent) of 16 banks continue to be a supervisory concern: 3 (37.5 percent) of 8 banks have a current composite rating of 4 or 5, and 5 (62.5 percent) of 8 banks have a current composite rating of 3. For these banks, the period of ongoing supervisory concern ranges from 18 months to 81 months. Of particular note, 5 (62.5 percent) of these 8 problem banks have been a supervisory concern for an extended period -- over 60 months. Figure 2 depicts the ongoing periods during which the eight problem banks have remained a supervisory concern.

Figure 2: Period of Supervisory Concern for Ongoing Problem Banks



Source: OIG Analysis of the FDIC's On-line Resources and Reports of Examination.

Peer Averages

One measure that could be considered in assessing the level of capital needed is the use of peer averages[5] or customized peer averages. While an analysis of the required capital level should not be based solely on a review of peer averages, they can provide insight into the operational adequacy of an institution and whether operational and financial objectives need improvement. However, DSC's analysis of the banks' peer averages was limited. Based on a review of the Reports of Examination, Summary Analysis of Examination Report (SAER) comments, and corrective action recommendation memoranda, supervisory personnel did not use peer averages or customized peer averages to support the assigned capital provision ratios. Of the 18 banks in our sample, 17 (94 percent) banks had been assigned a supervisory corrective action with a capital provision that had a ratio objective. These 17 banks were assigned a capital provision with a minimum ratio objective that was set below the bank's historical peer average.

In some circumstances, a bank's capital provision ratios should be set at or higher than the peer average. While a bank's peer average should not be considered the appropriate level of capital and the review of a bank's peer average ratio is not expected to be the only analysis performed, our sample results showed that a correlation exists between the bank's peer average and the determination of capital adequacy. Of the eight banks that have improved to a point of adequacy, four (50 percent) banks have current capital ratios approximately equal to or above the

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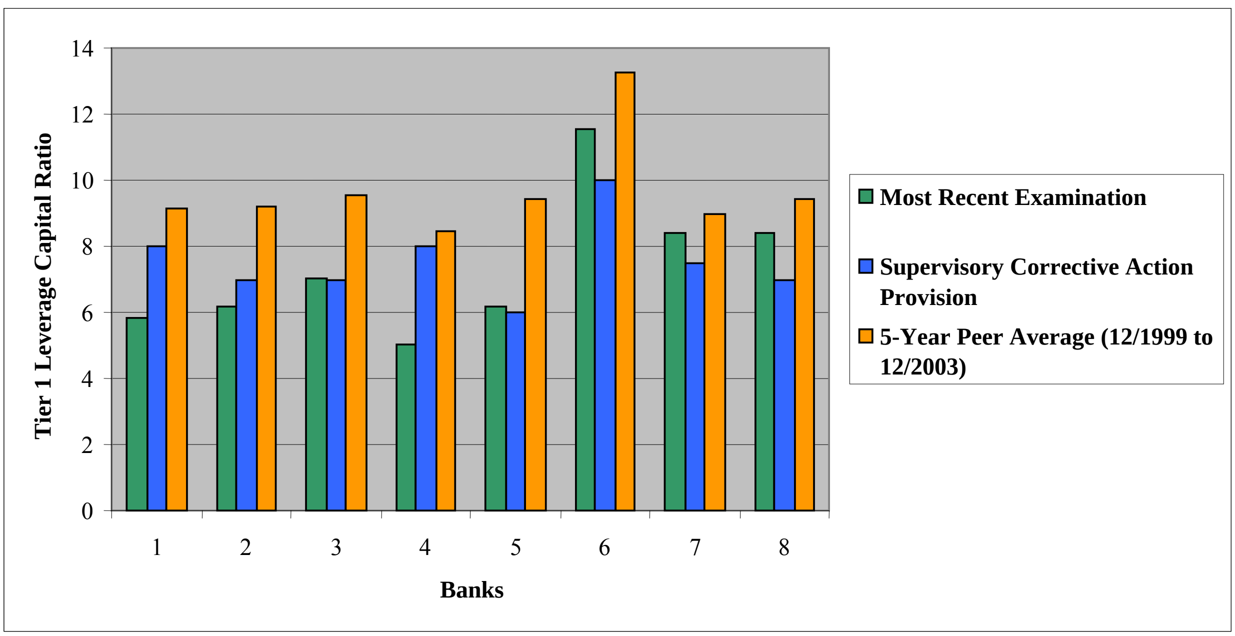
[5] According to the Federal Financial Institutions Examination Council's *A User's Guide for the Uniform Bank Performance Report*, banks are assigned to one primary peer group from which average ratios are calculated. Peer group averages are included in the Uniform Bank Performance Report to show the average performance of a group of banks with similar characteristics. This information can be used as a benchmark against which an individual bank's assets and liability structure and earnings may be measured. The peer group average for a given ratio is adjusted to eliminate the effect of banks above the 95th and below the 5th percentile. The resulting average in most cases is very close to the median or mid-point value for a given group of banks. Peer groups are defined by up to three criteria: asset size, number of banking offices, and location. Most banks are assigned to 1 of the 15 primary insured commercial bank peer groups. In addition, several primary line-of-business peer groups have been established, and these peer groups include Savings Banks, Credit Card Specialty Banks, and Bankers Banks.

banks' peer averages. Conversely, as shown in Figure 3, of the active banks that are still a supervisory concern, the most recent examinations show that the current capital ratios for all eight banks are below the 5-year peer averages. This indicates that if the supervisory objective was to achieve a capital ratio position that would be deemed adequate, the use of a bank's peer average should be considered in the determination of a bank's capital provision ratio. Figure 3 excludes the two banks that became inactive.

Furthermore, of the eight active banks in our sample that are still a supervisory concern, the most recent examinations show that five (62.5 percent) banks had a capital ratio position above the level set by the supervisory corrective action, and that capital was still not considered adequate. In essence, DSC's subsequent examinations have determined that certain banks' capital levels are inadequate despite meeting the levels set by the supervisory corrective actions. As evidenced by the examiners' conclusions, the established capital-level provisions for the banks we reviewed were insufficient to ensure that the banks were adequately capitalized and should have been reassessed. Figure 3 illustrates those eight banks that remain a supervisory concern and provides a comparison of the Tier 1 Leverage Capital ratio as of the bank's most recent examination, as stipulated within the supervisory corrective action's capital provision ratio and as a 5-year peer average.

Figure 3: Comparison of Examination Results, Supervisory Corrective Action Capital Provisions, and Peer Average Ratios for 3, 4, and 5 Rated Banks



Source: OIG Analysis of Uniform Bank Performance Reports, Reports of Examination, and the FDIC's On-line Resources. The OIG calculated the 5-year peer averages based on year-end data.

Advanced Modeling Techniques

Consideration could also be given to advanced modeling techniques of measuring and managing risk. These advanced modeling techniques could incorporate the internal allocation of economic capital that is based on a probabilistic assessment of potential future losses and is, therefore, a potentially more forward-looking measure of capital adequacy than traditional accounting measures. While the new capital adequacy framework commonly known as Basel II has not yet been implemented,[6] various quantitative measures that have been developed could also be employed, such as establishing a level of capital based on credit risk that takes into consideration internal loan rating and assigning risk-weights based on probability of default, loss given default, exposure at default, maturity, and default correlation. The analysis employed could be tailored to the size and sophistication of the bank and to the nature of the risk factors present within the institution. In addition, any methodology used should ensure that due consideration is given to quantitative and qualitative factors, to the bank's methodology for determining capital adequacy, and to the reconciliation of the various measures used.

DSC Management's Perspective

According to DSC management, one of their objectives in developing capital provisions for supervisory corrective actions is to have the bank raise additional capital as quickly as possible and then to maintain a specified capital level on an ongoing basis. To obtain bank management agreement, a lower level of capital may be agreed to by the FDIC than would normally be deemed necessary. If a bank does not agree or stipulate to the corrective action, then formal proceedings could ensue and a lengthy period may elapse between completion of an examination and the date of a formal hearing, which could expose the bank and the FDIC to additional risk of loss during the period.

DSC also pointed out that raising and maintaining a specific level of capital is one of several concurrent provisions that may be pursued in corrective actions. These provisions may be formulated in conjunction with one another, and consideration needs to be given to the overall strategy of effecting correction action. As a result, the overall strategy will be more important than obtaining a specific level of capital. Other corrective provisions may include, but not be limited to, directing a bank to provide for adequate Allowance for Loan and Lease Losses, ordering a bank to cease and desist from hazardous lending and collection practices, taking action to correct specific internal control weaknesses, requiring the formulation and implementation of comprehensive budgets to correct operating deficits, and correcting all noted violations.

[6] The Basel Committee on Banking Supervision has developed and proposed a new capital adequacy framework (Basel II) to update and improve the internationally recognized capital standards embodied in the 1988 Basel Capital Accord. Basel II brings a new approach to the regulatory capital framework and creates incentives for advancement in risk measurement and management processes at large and complex, internationally-active financial institutions. Although one of the goals of Basel II is to focus on internationally active banks, the underlying principles should be suitable for application to banks of varying levels of complexity and sophistication. The Basel Committee is comprised of representatives of the central bank and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg and Spain.

Conclusion

In view of DSC's success with corrective actions, we are not recommending changes to the process for determining capital provision requirements. However, the observations presented above are being provided for DSC's consideration in developing future capital provisions.

FINDING B: CAPITAL PROVISIONS AND PROMPT CORRECTIVE ACTION CAPITAL RATIOS

Supervisory personnel are not recommending capital provisions that encompass all of the PCA capital ratios. Specifically, supervisory personnel are not always establishing supervisory corrective actions that include capital provisions based on risk-based capital standards. Instead, capital provisions in supervisory corrective actions are typically established based on a leverage capital ratio. In addition, DSC's policies do not require supervisory personnel to use both leverage- and risk-based capital ratios in establishing a bank's capital-level position in supervisory corrective actions. As a result, the established capital provisions do not ensure that a bank stays adequately capitalized as defined by the PCA capital categories. Sole reliance on the Tier 1 Leverage Capital ratio could increase risk, delay supervisory action, and require the FDIC to initiate additional supervisory corrective actions and provisions if a bank's risk-based capital position deteriorates to the point where action is needed.

Regulatory and Supervisory Guidance

Part 325 of the FDIC Rules and Regulations sets forth the minimum leverage capital requirements for fundamentally sound, well-managed banks having no material or significant financial weaknesses. Part 325 was designed to establish uniform capital standards based on ratios of capital to total assets. The PCA capital categories are defined by the following ratios: Total Risk-Based Capital, Tier 1 Risk-Based Capital, and Tier 1 Leverage Capital, as well as Tangible Equity Capital for critically undercapitalized institutions. The FDIC recognized that the leverage ratios are a useful tool for assessing capital adequacy yet decided there was a need to make the risk-based ratios more explicitly and systematically sensitive to the risk profiles of individual banks. Therefore, the FDIC's Board of Directors adopted Part 325 Appendix A, *Statement of Policy on Risk-Based Capital*, which provides a risk-based capital framework to be used in the examination and supervisory process.

The DSC Examination Manual, *Case Manager Procedures Manual*, Capital Adequacy Examination Documentation (ED) Module, and *Formal and Informal Action Procedures Manual* (FIAP Manual) do not require all of the PCA capital ratios to be included in supervisory corrective actions. The Capital Adequacy ED Module instructs examiners to determine the need for administrative and enforcement actions and to formulate specific recommendations. However, the module does not provide guidance on how to formulate and establish specific capital provision levels. The FIAP Manual provides similar guidance. In addition, the manual provides a list of possible unsafe and unsound practices and the corresponding corrective measures that may be included in a C&D. The FIAP Manual explains that supervisory personnel may state the amount of required capital in a capital provision as either a ratio or a dollar amount. The ratio example in the manual shows only the Tier 1 Leverage Capital ratio and the manual does not discuss the need to formulate capital provisions that address both leverage and risk-based capital ratios.

Analysis of Leverage and Risk-Based Capital Provisions

Capital provisions frequently do not include risk-based capital ratios. Typically, supervisory corrective action capital provisions are based only on a leverage ratio. As noted earlier, the FDIC's Statement of Policy and other supervisory guidance emphasizes the need for and application of both leverage capital and risk-based capital standards. The FDIC's leverage capital ratios are calculated as the Tier 1 Leverage Capital ratio and as the Tangible Equity Capital ratio. The FDIC's risk-based capital ratios are calculated as the Tier 1 Risk-Based Capital ratio and the Total Risk-Based Capital ratio.

Of the 18 banks in our sample, 13 (72 percent) banks were subject to one or more supervisory corrective actions with a capital provision based only on the Tier 1 Leverage Capital ratio. Conversely, 4 (22 percent) of 18 banks were subject to a supervisory corrective action that designated a capital position based on a leverage ratio and a risk-based capital ratio. In particular, two banks were subject to one supervisory corrective action that designated a capital provision, including the Tier 1 Leverage Capital ratio, Tier 1 Risk-Based Capital ratio, and Total Risk-Based Capital ratio. The other two banks were subject to two supervisory corrective actions each. However, in each case, only one supervisory corrective action included the Tier 1 Leverage Capital ratio and the Total Risk-Based Capital ratio. For these two banks, MOUs were issued that did not designate a risk-based capital ratio position. Subsequent C&Ds for the two banks designated risk-based capital ratio positions. Table 2 on the next page identifies the ratios designated in each bank's supervisory corrective action(s).

Table 2: Ratios Designated in Supervisory Corrective Actions

Bank	Action	Tier 1 Leverage Capital Ratio	Tier 1 Risk-Based Capital Ratio	Total Risk-Based Capital Ratio
1	A	*		
2	B	*		
	C	*		
3	D	*		
	E	*		*
4	F			
	G	*		
5	H	*		
	I	*		*
6	J	*		
7	K			
8	L			
	M	*		
	N	*		
9	O	*		
	P	*		
	Q	*		
10	R	*		
	S	*		
	T	*		
11	U	*	*	*
12	V			
	W	*		
13	X	*		
14	Y	*	*	*
15	Z	*		
	AA	*		
16	AB	*		
	AC	*		
17	AD	*		
	AE	*		
	AF	*		
18	AG	*		

Source: OIG Analysis of the FDIC's On-line Resources and Reports of Examination.

Based on our review of each bank's quarterly performance ratios, and as depicted in Appendix III, we noted that 8 (44 percent) of 18 banks in our sample fell below the PCA regulatory minimum capital thresholds for Tier 1 Leverage Capital or Total Risk-Based Capital subsequent to the issuance of a supervisory corrective action and the bank achieving compliance with any of their outstanding capital provision ratios. This number increases to 12 (67 percent) of 18 banks, when banks are included that had a supervisory corrective action without a capital provision or had a capital provision that did not address all of the PCA capital requirements.

We also noted that, considering the time both before and after the issuance of a supervisory corrective action:

- 11 of 18 banks in our sample fell below the PCA minimum requirement for the Tier 1 Leverage Capital ratio.
- 12 of 18 banks in our sample fell below the PCA minimum requirement for the Total Risk-Based Capital ratio. This ratio was only included in four corrective actions.
- 4 of 18 banks in our sample fell below the PCA minimum requirement for the Total Risk-Based Capital ratio that did not fall below the minimum requirement for the Tier 1 Leverage Capital ratio. In other words, these banks were found to be undercapitalized for regulatory classification purposes based on their risk-based capital levels as opposed to their leverage capital. For three of these banks, the corrective actions did not include a risk-based capital ratio. This highlights the need for further consideration of the risk-based capital ratios when setting capital provisions.

Supervisory Guidance Needed to Ensure Consideration of Risk-Based Capital Position

DSC's policies do not require supervisory personnel to determine and establish supervisory corrective action provisions based on both leverage and risk-based capital standards. In particular, the decision to consider and use both leverage and risk-based capital ratios in supervisory corrective actions is left to the discretion of supervisory personnel. Consequently, little consideration may be given to risk-based capital standards when supervisory corrective action provisions are established. Guidance should address not only the use of the Tier 1 Leverage Capital ratio, which may offer a simpler and potentially more expedient measure of capital, but also an appropriate risk-based capital position.

For the banks in our review, the established capital-level provisions did not sufficiently address risk-based capital standards, and the capital-level provisions established, if any, did not ensure that a problem bank remained adequately capitalized per the PCA capital categories. Depending on a bank's financial structure and asset composition, the impact of unexpected losses and declines in earnings could result in a bank's capital levels falling below the minimum standards for risk-based capital, while the bank's leverage capital position maintains the PCA classification of "Adequately Capitalized."

Conclusion

DSC management provided its view on the need to establish supervisory corrective action provisions that are based on both leverage and risk-based capital standards. Specifically, DSC stated that the PCA risk-based capital standards still applied whether or not the supervisory corrective action provided a risk-based capital provision ratio. However, based on our review, the established capital-level provisions did not sufficiently address risk-based capital standards and did not ensure that a problem bank remained adequately capitalized based on PCA capital standards. Sole reliance on the Tier 1 Leverage Capital ratio could require the FDIC to initiate additional supervisory corrective actions and provisions as a bank's risk-based capital position deteriorates.

Recommendation

We recommend that the Director, DSC, revise guidance to supervisory personnel to discuss the use and consideration of Tier 1 Leverage Capital, Tier 1 Risk-Based Capital, and Total Risk-Based Capital ratios in the formulation and recommendation of capital-level provisions.

CORPORATION COMMENTS AND OIG EVALUATION

On July 13, 2005, the DSC Director provided a written response to the draft report. The response is presented in its entirety as Appendix IV to this report. DSC generally concurred with the findings of the report and agreed to implement the recommendation. Specifically, DSC management believed that they considered and addressed risk-based and PCA capital standards, but also agreed that there are benefits to clarifying or enhancing DSC's existing guidance and stated that they will revise and issue any necessary guidance to examiners by March 31, 2006. DSC's planned action is responsive to our recommendation. Accordingly, the recommendation is resolved but will remain undispositioned and open until we have determined that the agreed-to corrective action has been completed and is effective. Appendix V contains a summary of management's response to the recommendation.

APPENDIX I

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of the audit was to determine whether the process used by DSC for determining capital provision requirements established under supervisory corrective actions for problem banks is adequate. To accomplish our objective, we reviewed DSC's policies and procedures related to capital provision requirements and determined how DSC established, enforced, and reassessed capital provisions over time. We also reviewed the results of examinations associated with a judgmentally selected sample of banks, and we reviewed DSC's supervisory corrective actions and follow-up activity in response to capital deficiencies identified during the examinations.

We obtained a universe of all FDIC-supervised, state nonmember banks with at least one safety and soundness composite rating of 5 over a 4-year period. From September 2000 through August 2004, there were approximately 27 state nonmember banks with at least one composite rating of 5, excluding those institutions that failed, closed, or merged prior to December 2003. From this universe, a sample of 18 banks within the Dallas and Chicago Regions was selected. We selected ten banks from the DSC Chicago Region and eight banks from the DSC Dallas Region. One bank from the Dallas Region was not selected due to a recent charter conversion. We selected these 18 banks to review because of the higher concentration level of 5 rated banks within these two regions.

We performed our audit from July 2004 through May 2005 in accordance with generally accepted government auditing standards. To accomplish the audit objectives, we:

- reviewed DSC policies and procedures pertaining to the evaluation of capital and the assignment of supervisory corrective actions.
- reviewed and analyzed Reports of Examination and SAER comments prepared by the FDIC and state banking agencies for the banks in our sample during the last 5 years;
- reviewed and analyzed related Uniform Bank Performance Reports;
- reviewed and analyzed examination working papers and corrective action recommendation memoranda; and
- interviewed DSC policymakers in Washington, D.C., and regional office personnel in Dallas.

Government Performance and Results Act, Reliance on Computer-Processed Data, Management Controls, Compliance with Laws and Regulations, and Fraud and Illegal Acts

The Government Performance and Results Act of 1993 directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, manage and measure results to justify appropriations and authorizations, and design budgets that reflect strategic missions. In this audit, we reviewed the FDIC's 2004 Annual Performance Plan and the FDIC's Strategic Plan 2005-2010. The FDIC has annual performance goals that address the need to take prompt supervisory action to address concerns identified in problem institutions, and that address the need to monitor those banks' compliance with formal and informal supervisory corrective actions. However, these goals do not specifically address the subject of our audit.

We conducted tests to determine the reliability of computer-processed data obtained from the Uniform Bank Performance Reports. Based on the review of the computation of selected capital ratios, the computer-processed data appeared reliable.

We gained an understanding of relevant control activities by examining DSC-applicable policies and procedures as presented in the FDIC's Rules and Regulations, FDIC's Statements of Policy, DSC Examination Manual, *Case Manager Procedures Manual*, FIAP Manual, ED Modules, and Regional Director Memoranda.

Regarding compliance with laws and regulations, we gained an understanding of aspects of the FDI Act and the requirements of Part 325 of the FDIC's Rules and Regulations and evaluated the FDIC's establishment and implementation of procedures for examining the sampled institutions' regulatory compliance. Our audit program also included steps for providing reasonable assurance of detecting fraud or illegal acts.

APPENDIX II

REGULATORY CAPITAL

The FDIC has issued several capital-based regulations. These regulations, in part, establish minimum capital standards and establish a framework for taking supervisory actions for institutions that are not adequately capitalized. Part 325 of the FDIC Rules and Regulations establishes the criteria and standards the FDIC uses in calculating the minimum leverage capital requirement and in determining capital adequacy. Part 325 Appendix A - *Statement of Policy on Risk-Based Capital*, establishes a risk-adjusted capital framework which, together with the leverage capital standard, is used in the examination and supervisory process. The risk-based framework includes a definition of capital for risk-based capital purposes, a system for calculating risk-weighted assets[7] by assigning assets and off-balance sheet items to broad risk categories, and a minimum supervisory ratio of capital to risk-weighted assets. Part 325 of the FDIC Rules and Regulations also implements Section 38 of the FDI Act by establishing a framework for taking prompt corrective action against insured state nonmember banks that are not adequately capitalized.

Institutions are expected, at a minimum, to maintain capital levels that meet both the leverage capital ratio[8] and the risk-based capital ratio[9] requirements. Part 325 sets forth minimum acceptable capital requirements for fundamentally sound, well-managed institutions having no material or significant weaknesses. The minimum leverage capital requirement is that a bank shall maintain a Tier 1 Leverage Capital ratio of not less than 3 percent if the bank has a composite 1 rating and is not anticipating or experiencing any significant growth and has well-diversified risk, including interest rate risk, excellent asset quality, high liquidity, and good earnings. All others not meeting the above criteria should maintain a Tier 1 Leverage Capital

[7] Under the risk-based capital framework, a bank's balance sheet assets and credit equivalent amounts of off-balance sheet items are generally assigned to one of four broad risk categories (0, 20, 50, and 100 percent) according to the obligor, or if relevant, the guarantor or the nature of the collateral. Although the majority of assets and off-balance sheet items fall within one of the four broad risk categories, there are exceptions that fall outside of the general categories. In addition, in 1999, the agencies introduced a 200 percent risk-weighted category. This category applies to externally rated recourse obligations, direct credit substitutes, residual interest (other than credit-enhancing interest-only strips), and asset- and mortgage-backed securities that are rated one category below the lowest investment grade category or non-rated positions for which the bank deems that the credit risk is equivalent to one category below investment grade (e.g., BB).

[8] The Tier 1 Leverage Capital ratio is computed by taking a bank's Tier 1 Capital and dividing it by Total Assets. Tier 1 Capital is composed of a bank's core capital elements, such as common stockholders' equity, noncumulative perpetual preferred stock, and minority interest in consolidated subsidiaries, less various exclusions and disallowed items.

[9] The Total Risk-Based Capital ratio is computed by adding a bank's Tier 1 Capital, Tier 2 Capital, and Tier 3 Capital and dividing the sum by Total Risk-Weighted Assets. Tier 2 Capital is composed of a bank's supplementary capital elements, such as a portion of the allowance for loan and lease losses, cumulative perpetual preferred stock, long-term preferred stock, and net unrealized holding gains on equity securities. Tier 3 Capital is capital allocated for market risk.

ratio of not less than 4 percent. Any bank that has less than the minimum leverage capital requirement is deemed to be in violation of Part 325 and engaged in an unsafe or unsound practice pursuant to section 8(b) and/or 8(c) of the FDI Act, unless the bank has entered into and is in compliance with a written plan approved by the FDIC. If a bank has a leverage ratio less than 2 percent, it is deemed to be operating in an unsafe or unsound condition pursuant to section 8(a) of the FDI Act. The minimum risk-based capital requirement is that a bank shall maintain a Total Risk-Based Capital ratio of qualifying total capital to risk-weighted assets equal to at least 8 percent, at least half of which (4 percent) must be comprised of Tier 1 capital. The risk-based capital measure is more explicitly and systematically sensitive to the risk profiles of individual banks.

Pursuant to Section 38 of the FDI Act, Part 325 Subpart B – *Prompt Corrective Action (PCA)* defines the various PCA capital categories. Table 3 summarizes the PCA capital categories.

Table 3: Prompt Corrective Action Capital Categories

	Leverage	Tier 1 Risk-Based	Total Risk-Based
Well Capitalized	>= 5% and	>= 6% and	>= 10%
	And is not subject to any written agreement, order, capital directive, or prompt corrective action directive to meet and maintain a specific level for any capital measure.		
Adequately Capitalized	>= 4%* or	>= 4% or	>= 8%
	And does not meet the definition of a well capitalized bank. *or a Leverage ratio of 3% if the bank is rated a composite 1 and is not experiencing or anticipating significant growth and has well diversified risk.		
Undercapitalized	< 4%* or	< 4% or	< 8%
	*or <3% if the bank is rated composite 1 and is not experiencing or anticipating significant growth.		
Significantly Undercapitalized	< 3% or	< 3% or	< 6%
Critically Undercapitalized	Tangible equity capital ratio that is <2%		

Source: DSC Examination Manual

The Prompt Corrective Action provisions establish limits and impose various requirements for protecting or restoring capital depending on an institution's PCA capital category.

The FDIC is not precluded from requiring an institution to maintain a higher capital level than the minimum standards based on the institution's particular risk profile. For banks that are fundamentally sound and well-managed, the minimum leverage and risk-based capital ratios are generally viewed as the minimum acceptable standard. This treatment generally applies to those banks evidencing a level of risk that is no greater than that normally associated with a composite rating of 1 or 2. For banks that evidence a level of risk normally associated with a composite rating of 3, 4, or 5, these banks will be required to maintain capital at a level that is higher than the minimum regulatory requirement and at a level deemed appropriate in relation to the degree of risk within the institution. These higher capital levels should normally be addressed through

MOUs between the FDIC and the bank or, in cases of more pronounced risk, through the use of formal enforcement actions under Section 8 of the FDI Act.

APPENDIX III

CAPITAL MAINTENANCE IN RELATION TO PROMPT CORRECTIVE ACTION REGULATORY MINIMUMS

Table 4 shows those banks that had their Tier 1 Leverage Capital and Total Risk-Based Capital ratios fall below the PCA regulatory minimum levels. Of the 18 banks in our sample, 8 (44 percent) banks fell below the PCA regulatory minimum capital threshold subsequent to the issuance of a supervisory corrective action and the bank achieving compliance with any outstanding capital provision ratios.

Table 4: Quarterly Periods When Capital Ratios Fell Below Prompt Corrective Action Regulatory Minimum Levels

Action Placed	1	2	3	4	5	6	7	8	9
Q1	√	√	√	√	√	√	XXX	√	√
Q2	√	√	√	√	√	√		√	√
Q3	√	√	√	√	√	√		√	√
Q4	√	√	√	√	√	√		X	√
Q5	√	√	√	√	X	√		√	√
Q6		√	√	√	√	√		√	√
Q7		√	√	X	√	√		√	√
Q8		√	√	√	√	√		√	√
Q9		√	X	√	√	X		√	√
Q10		√	√	√	√	√		√	√
Q11		XX	√	√	√	√		√	√
Q12		√	X	√	√	√		√	√
Q13		√	XX		√	√		√	√
Q14		√	√			√		√	√
Q15		√	√			√			√
Q16		√	√			√			√
Q17		√	√			√			√
Q18		√	√			√			√
Q19			√			√			√
Q20			√			√			√
Q21			√			√			

APPENDIX III

Action Placed	10	11	12	13	14	15	16	17	18
Q1	√	√	X	XX	√	√	√	√	√
Q2	√	√	X	√	√	X	√	√	√
Q3	√	√	√	√	√	√	√	√	X
Q4	√	√	√	√	√	√	X	√	X
Q5	√	√	√	√	√	√	XX	X	√
Q6	√	√	√	√	√	√	XX	X	√
Q7	√	√	√	√	√	√	X	√	√
Q8	√		√	√		√	X	√	√
Q9	√		√	√		√		√	√
Q10	√		√	√		√		√	√
Q11	√		√	√		√		√	√
Q12	√		√	√		√		√	√
Q13	√		√	√		√		√	√
Q14	√		√	√				√	√
Q15	√								
Q16	√								
Q17	√								
Q18	√								
Q19	√								
Q20	√								
Q21	√								

Source: OIG analysis of Uniform Bank Performance Reports. The first quarter presented corresponds to the quarter end just previous to the date that the supervisory corrective actions with a capital provision were issued. This quarter provides the first financial measurement that would be available when a supervisory corrective action is issued. For those supervisory corrective actions without a capital provision, the first quarter presented corresponds to the first time period that one of the bank's capital ratios fell below the PCA minimum-level requirements.

Legend:
√ = Met the PCA minimum levels and capital provision ratio requirements.
√ = Met the PCA minimum capital level requirement, but not the outstanding capital provision ratio.
X = Fell into the PCA capital category of Undercapitalized.
XX = Fell into the PCA capital category of Significantly Undercapitalized.
XXX = Fell into the PCA capital category of Critically Undercapitalized.

CORPORATION COMMENTS

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

DATE: July 13, 2005

TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Michael J. Zamorski, Director
Division of Supervision and Consumer Protection

[Electronically produced version; original signed by Michael J. Zamorski]

SUBJECT: Response to OIG Draft Report Entitled: *Capital Provision Requirements Established Under Supervisory Corrective Actions* (Assignment No. 2004-050)

Thank you for the opportunity to respond to your draft audit report, *Capital Provision Requirements Established Under Supervisory Corrective Actions.* We agree with the overall assessment that the Division of Supervision and Consumer Protection (DSC) has been successful in using capital provisions in supervisory corrective actions. Further, we are gratified that you found that bank examiners adhere to DSC policies regarding both the analysis of capital adequacy and the implementation of capital provisions within supervisory corrective actions.

FDIC Inspector General Recommendation

The draft audit report contained one recommendation:

> *We recommend that the Director, DSC revise guidance to supervisory personnel to discuss the use and consideration of Tier 1 Leverage Capital, Tier 1 Risk-Based Capital, and Total Risk-Based Capital ratios in the formulation and recommendation of capital-level provisions.*

DSC Response:

We generally concur with the findings of the audit report. While we believe that we sufficiently consider and address risk-based capital standards and Prompt Corrective Action capital standards in implementing our supervisory corrective actions, we also agree there are benefits to clarifying or enhancing our existing guidance. We will revise and issue any necessary guidance to examiners by March 31, 2006.

APPENDIX V

MANAGEMENT RESPONSE TO RECOMMENDATION

This table presents the management response on the recommendation in our report and the status of the recommendation as of the date of report issuance.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Dispositioned:[b] Yes or No	Open or Closed[c]
1	DSC will revise and issue any necessary guidance to examiners concerning the use and consideration of the Tier 1 Leverage Capital, Tier 1 Risk-Based Capital, and Total Risk-Based Capital ratios in the formulation and recommendation of capital-level provisions.	March 31, 2006	N/A	Yes	No	Open

[a] Resolved – (1) Management concurs with the recommendation, and the planned corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but planned alternative action is acceptable to the OIG.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Dispositioned – The agreed-upon corrective action must be implemented, determined to be effective, and the actual amounts of monetary benefits achieved through implementation identified. The OIG is responsible for determining whether the documentation provided by management is adequate to disposition the recommendation.

[c] Once the OIG dispositions the recommendation, it can then be closed.