Office of Inspector General

September 12, 2003
Audit Report No. 03-038

The Role of Prompt Corrective Action as Part of the Enforcement Process

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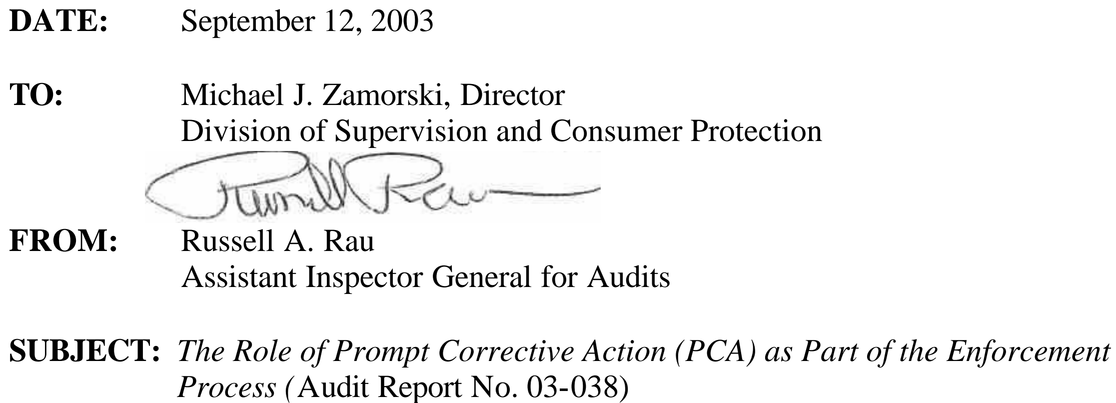
Federal Deposit Insurance Corporation Office of Audits
Washington, D.C. 20434 Office of Inspector General

DATE: September 12, 2003

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



FROM: Russell A. Rau
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SUBJECT: *The Role of Prompt Corrective Action (PCA) as Part of the Enforcement Process (* Audit Report No. 03-038)

This report presents the results of an audit we conducted to determine whether the Prompt Corrective Action (PCA) provisions were used as part of the FDIC's enforcement process and served to reduce the losses to the deposit insurance funds. This is a follow-up audit to our earlier report entitled *The Effectiveness of Prompt Corrective Action Provisions in Preventing or Reducing Losses to the Deposit Insurance Funds,* dated March 26, 2002. Our earlier audit focused on determining whether prompt corrective action provisions were implemented in a timely manner for Superior Bank (Superior), First National Bank of Keystone (Keystone), and Pacific Thrift & Loan Company (PTL) and whether those actions prevented or reduced losses to the insurance funds.

Pursuant to our earlier audit, and in consultation with the FDIC's Divisions of Supervision and Consumer Protection (DSC) and Resolutions and Receiverships (DRR), we expanded our work to a larger sample of 11 FDIC-supervised institutions to address our stated objectives. We selected a sample of failed as well as open institutions so that we could determine whether PCA provisions were used or should have been used.[1] See Appendix I for the list of 11 institutions that we reviewed.[2]

In performing this audit, we conducted case studies of the 11 institutions to gain insight into the use of PCA provisions and their relation to the other elements of the FDIC's supervisory authority. Appendix II provides additional details on our objectives, scope, and methodology. We also shared our case histories with the DSC, Legal Division, Division of Insurance and Research (DIR), and DRR. In addition, we shared a working draft of this report with the DSC, DRR, DIR, and Legal Division. We have included their comments, where appropriate.

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[1] Throughout this report, we use the term failed banks to mean banks closed as well as ones acquired by other banks.
[2] As of May 31, 2003, six of these banks were closed, two had been acquired, and three remained open. To protect the identity of the open institutions, we refer to them throughout our report as Open Banks #1, #2, and #3.

BACKGROUND

In response to the criticism that federal banking regulators were not taking prompt and forceful action to minimize or prevent losses to the insurance funds stemming from bank and thrift failures, the Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Public Law 102-242, to improve the supervision and examination of depository institutions and protect the insurance funds from further losses.

FDICIA's Prompt Regulatory Action provisions created two new sections in the Federal Deposit Insurance Act—sections 38 and 39, codified to 12 U.S.C. §1831o and 1831p-1—which required that regulators establish a two-part regulatory framework to improve safeguards for the deposit insurance funds. 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.

The first part of the framework, Section 38, *Prompt Corrective Action*, of the FDI Act requires federal regulators to place depository institutions into one of five categories on the basis of their capital levels and mandates increasingly severe restrictions and supervisory actions as an institution's capital condition deteriorates.[3] The section further requires regulators to define capital-level criteria for four of the five categories. The four categories are identified as well capitalized, adequately capitalized, undercapitalized, and significantly undercapitalized. Regulators must also set the threshold for the fifth category, which is identified as critically undercapitalized, at no less than 2 percent of tangible equity capital.[4] Section 38 establishes a system of restrictions and 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 to monitor the implementation of approved plans.

The regulators are generally required to close critically undercapitalized institutions within a 90-day period. In addition, without the FDIC's prior written approval, section 38 restricts depository institutions in the three lowest capital categories from engaging in certain activities such as acquisition of branches or new lines of business that could increase the risk of losses to the deposit insurance funds.

The second part of the framework, Section 39, *Standards for Safety and Soundness*, directs regulatory attention to the non-capital areas of an institution's activities as they relate 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

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[3] A bank's primary federal regulator is determined by the bank's charter and the status of membership in the Federal Reserve System. The FDIC is the primary federal regulator for state-chartered banks that are not members of the Federal Reserve System. The Office of the Comptroller of the Currency (OCC) is the primary federal regulator for all national banks. The Board of Governors of the Federal Reserve System (FRB) is the primary federal regulator for state-chartered banks that are members of the Federal Reserve System. The Office of Thrift Supervision (OTS) is the primary federal regulator for federal and state-chartered savings associations.

[4] See Appendix V for a glossary of terms.

quality, earnings, and stock valuation; and (3) compensation. See Appendix III for additional background discussion of sections 38 and 39.

RESULTS OF AUDIT

The FDIC generally used PCA directives as part of the supervisory process, in conjunction with other supervisory actions, once institutions' capital levels reached designated thresholds.[5] Specifically, the FDIC used PCA directives in 8 (7 failed and 1 open) of 11 institutions that we reviewed, and its use of PCA served to prevent or reduce losses to the deposit insurance funds. Prior to the enactment of section 38, there was no mandate to close an institution before its capital was depleted. However, this section generally instituted a requirement that regulators close institutions when their tangible equity drops to 2 percent or less of their total assets. Because of PCA directives, insurance fund losses were prevented in two institutions when other institutions acquired them. In four other institutions, insurance fund losses were reduced when institutions were closed before they became insolvent.

PCA directives were used in 8 of 11 institutions in our sample; however, we identified a number of factors that delay the use of section 38 and impact the effectiveness of its capital-related provisions. Specifically:

- PCA's focus is on capital, and because capital can be a lagging indicator of an institution's financial health, a bank's capital can remain in the "well to adequate" range long after its operations have begun to deteriorate from problems with management, asset quality, or internal controls. Our review of seven failed institutions for which the FDIC issued PCA directives showed that for those seven cases, one or more examinations revealed deteriorating conditions in various aspects of bank operations before capital began to deteriorate.

- Capital ratios reported by institutions in their Call Reports did not always reflect actual financial conditions. Capital ratios for PCA purposes are reported every quarter by institutions in their Call Reports. However, apart from some edits and validation checks, the FDIC verifies the accuracy of this information only during examinations. Consequently, depending on whether an institution's examination cycle is 12 or 18 months, erroneous or intentionally misleading financial information may go undetected by the FDIC for a period of a year or more. We observed that for nine institutions, the FDIC lowered the capital categories reported by the banks in Call Reports by one or more levels during examinations.

- Institutions increased their capital before or after the issuance of PCA directives and thus avoided implementation of PCA directives or closure.

[5] Throughout this report, we use the term PCA directive to mean a Notice of Capital Category or a PCA directive issued to the institutions. Both are used to implement section 38 provisions.

Various means were used to increase capital – assets were sold, income was transferred from another affiliate, in-kind capital was contributed, and cash was injected. These forms of capital infusion are accepted business practices, and additional capital strengthens the financial condition of institutions. Infusions can, nevertheless, temporarily delay the institutions' capital levels from triggering PCA directives. In other cases, infusions can increase the capital levels above the threshold after a PCA directive has been issued.

- The current method of computing capital does not take into account risks related to subprime loans. That is, the federal banking regulators currently do not require institutions in their Call Reports to risk-weight subprime loans commensurate with the risks associated with those loans. Consequently, the capital ratios reported in Call Reports for institutions engaged in subprime lending might be overstated, thus delaying the initiation of PCA provisions.

Although the primary focus of section 38 is capital, sections 38 and 39 also provide for certain actions based on non-capital factors to facilitate the issuance of PCA directives or to address non-capital problems. Specifically, section 38(g) allows regulators to reclassify the capital categories of institutions based on non-capital factors. However, the FDIC did not use this provision for any of the institutions in our sample. Also, section 38(f)(2)(F) authorizes the regulatory agencies to require an institution to improve management when the regulators consider management to be deficient. The FDIC used this provision in 2 of the 11 institutions we reviewed. Finally, section 39 provides for regulators to require a compliance plan from institutions when regulators identify problems with operations, management, asset quality, earnings, stock valuation, and compensation. The FDIC used this provision in 1 of the 11 institutions. Our analyses of the sections indicated that these provisions do not provide objective or measurable criteria for implementation and, in some instances, placed restrictions on their use. Consequently, these provisions were seldom used, and the FDIC may have lost opportunities to initiate additional supervisory actions to address problems.

SECTION 38 CAPITAL-RELATED PROVISIONS

PCA DIRECTIVES WERE PART OF THE FDIC'S SUPERVISORY PROCESS AND PREVENTED OR REDUCED LOSSES TO THE DEPOSIT INSURANCE FUNDS

Of the 11 institutions that we reviewed, the FDIC used PCA directives as part of the enforcement process in 8 of these institutions after their capital levels reached designated thresholds. Use of the PCA directives served to prevent or reduce losses to the deposit insurance funds. Section 38(c) created a capital-based framework for bank and thrift oversight that places financial institutions into one of five capital categories. Section 38 also restricts depository institutions in the three lowest capital categories from engaging in certain activities such as acquisition of branches or new lines of business that could increase the risk of losses to the federal deposit insurance funds. Further, this section

also established a system of mandatory supervisory actions that are to be triggered at the three lowest capital levels—undercapitalized, significantly undercapitalized, and critically undercapitalized.

Table 1 identifies the eight institutions for which the FDIC used PCA directives and the status of the institutions.

Table 1: Banks for Which PCA Directives Were Used

Name	PCA Capital Level at Which PCA Directive Was First Used	Date of PCA Directive	Institution's Status
Victory State Bank	Undercapitalized	11/6/98	Closed – 3/26/99
Bank of Honolulu	Significantly Undercapitalized	8/4/00	Closed – 10/13/00
Bank of Alamo	Critically Undercapitalized	8/29/02	Closed – 11/8/02
Salt Lick Deposit Bank	Critically Undercapitalized	4/17/01	Acquired – 5/9/01
Bank of Sierra Blanca	Significantly Undercapitalized	8/16/00	Closed – 1/18/02
Home State Bank	Significantly Undercapitalized	5/16/00	Acquired – 12/29/00
First Alliance Bank & Trust	Undercapitalized	7/6/00	Closed – 2/2/01
Open Bank # 2	Undercapitalized	12/31/01	Open

Source: OIG analysis of institutions for which PCA directives were used.

Of the remaining three institutions, a PCA directive was not used for one failed institution, the Bank of Falkner, because it was closed immediately after the detection of accounting improprieties. The other two institutions are open, and the FDIC had not used PCA directives because the institutions' capital levels had not reached the thresholds that require such action.

Use of PCA directives served to prevent or reduce losses to the deposit insurance funds. Prior to the enactment of section 38, there was no mandate to close an institution before the institution's capital was depleted. Section 38 generally requires regulators to close institutions when their tangible equity drops to 2 percent or less of their total assets, thereby reducing instances of seriously troubled institutions compounding their losses by continuing to operate. Therefore, institution management sought a buyer for institutions with less than 2 percent tangible equity, which prevented losses to the deposit insurance funds. When institutions with less than 2 percent tangible equity were closed, the decision was made to close the banks before they became insolvent, thus minimizing losses to the deposit insurance funds.

One of the factors that section 38 was meant to address was excessive forbearance of federal regulators. Prior to enactment of this section, the banking 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 its report issued in 1991, the U.S. General Accounting Office (GAO) noted that regulators had a common philosophy of trying to work informally and cooperatively with troubled institutions.[6] This approach, in combination with regulators' wide discretion in the oversight of

[6] See GAO/GGD-91-26, entitled *Bank Supervision: Prompt and Forceful Regulatory Action Needed,* dated April 15, 1991.

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 deposit insurance funds.

In addressing this situation, section 38 removed some regulatory discretion by requiring stringent action to be taken against critically undercapitalized institutions. After an institution becomes critically undercapitalized, PCA gives the regulators 90 days to either place the institution into receivership or conservatorship or take other action that would better prevent or minimize long-term losses to the insurance funds.

In addition, in its report issued in 1996, the GAO stated that according to regulators and banking industry analysts, section 38 provides depository institutions with strong incentives to raise additional equity capital.[7] These officials explained that financial institutions were concerned about the potential ramifications of becoming undercapitalized. Also, 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.

Attempting to compute savings resulting from the use of PCA directives would be very complex and require making numerous assumptions and estimations. However, the requirement that institutions be closed within 90 days of reaching 2 percent tangible equity provides a means to observe whether the institutions were acquired or closed before they became insolvent. Of the eight failed institutions in our sample, the FDIC used PCA directives in seven institutions as discussed earlier. Our observations regarding (1) the time lapse between the use of PCA directives and the closure or acquisition and (2) capital available at the time the banks were closed are presented in Table 2.

Table 2: Time Lapse Between Use of PCA Directives and Closure/Acquisition and Capital Available at the Time of Closure

Name	Date of PCA Directive	Acquisition/ Closure Date	Elapsed Time	Capital at the Time of Closure*
Victory State Bank	11/6/98	Closed – 3/26/99	5 months	$689,729
Bank of Honolulu	8/4/00	Closed – 10/13/00	2 months	$1,965,157
Bank of Alamo	8/29/02	Closed – 11/8/02	2 months	$3,314,582
Salt Lick Deposit Bank	4/17/01	Acquired – 5/9/01	1 month	N/A
Bank of Sierra Blanca	8/16/00	Closed – 1/18/02	17 months	($208,385)
Home State Bank	5/16/00	Acquired – 12/29/00	7 months	N/A
First Alliance Bank & Trust	7/6/00	Closed – 2/2/01	7 months	$510,391

Source: OIG analysis of institutions in which the FDIC issued a PCA directive.
* Amounts shown in this column were as of the date of bank closure. The final loss to the insurance funds depends on the proceeds received from the sale of assets available at closure.

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[7] See GAO/GGD 97-18, entitled *Bank and Thrift Regulation – Implementation of FDICIA's Prompt Regulatory Action Provisions,* dated November 21, 1996.

Analysis of these banks indicates that six out of seven institutions closed within 7 months after the FDIC used a PCA directive. In the case of the seventh bank, the Bank of Sierra Blanca, the bank's directors made three capital injections over a 9-month period, thus extending the eventual closure to 17 months. Of the 7 failed banks, two banks were acquired by other institutions, without financial assistance from the FDIC, after PCA directives were used and the directives thus served to prevent losses to the insurance funds. Of the remaining five banks, four were closed after PCA directives were used but before they became insolvent. For the remaining bank—Bank of Sierra Blanca—the FDIC gave 45 days to submit a revised capital plan after the bank was identified as "critically undercapitalized." However, a subsequent review by the bank's data processing servicer led to the identification of $452,000 in liabilities that had not been properly reflected on the bank's balance sheet. As a result, the bank's capital had eroded by the time the bank was closed.

In summary, the FDIC was able to prevent fund losses in two banks that were acquired by other institutions and minimize the losses for four banks by closing them before they became insolvent. Had it not been for the PCA provisions, which required action by the regulators when the tangible capital dropped to 2 percent, there was a possibility that these banks would have been allowed to operate until their equity was totally depleted or they became insolvent.

> By setting the closure of banks to 2 percent capital instead of insolvency, troubled banks begin their last-ditch efforts to recapitalize or merge earlier than they did prior to FDICIA. This increases the chances that their efforts to find a private sector solution and avoid failure will succeed.
>
> Source: FDIC Division of Insurance and Research

OTHER SUPERVISORY ACTIONS TAKEN PRIOR TO THE ISSUANCE OF PCA DIRECTIVES

During the periods leading up to the issuance of PCA directives in the banks we reviewed, the FDIC addressed problems that were initially not related to capital. Our review showed that for institutions with safety and soundness concerns identified as well capitalized or adequately capitalized, PCA does not afford the FDIC with an immediate supervisory remedy. PCA directives can be issued only after a problem institution's capital category crosses the undercapitalized threshold, which our analysis has shown trails the first identification of significant safety and soundness issues. However, the FDIC initiated other supervisory actions to address various problems prior to a bank's becoming undercapitalized. In fact, the supervisory actions taken before PCA directives were issued also included some of the capital-related provisions in section 38.

As discussed in the next section of our report, capital is a lagging indicator, and the institutions in our sample of banks first exhibited problems unrelated to their capital. However, the FDIC and the states addressed these problems through the use of other available supervisory actions before issuing PCA directives such as Board Resolutions,

Memorandums of Understanding (MOU), Cease and Desist Orders (C&D), State Commitment Letters, and written agreements. PCA directives were issued for 8 of the 11 banks in our sample. The CAMELS ratings provide a clear indication of the breadth of the problems these banks were experiencing before their capital conditions deteriorated to the point where PCA directives were issued. Examples of the problems follow:

- Deficiencies related to management and Board of Directors oversight.
- Lack of adequate internal control processes and procedures.
- Lack of or inadequate written loan policies and procedures.
- Unsound lending practices.
- Inadequate provisions for Allowance for Loan and Lease Losses. [8]
- Violations of laws and regulations.

Table 3 provides the CAMELS rating and the chronology of supervisory and PCA actions initiated by the examiners for the eight banks, including the dates on which these actions became effective.

[8] The Interagency Policy Statement on Allowances for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Associations, dated July 25, 2001, clarifies that the board of directors of each institution is responsible for ensuring that controls are in place to determine the appropriate level of ALLL.

Table 3: Supervisory Actions Taken Prior to PCA Directives

Bank Name	Supervisory Actions				
Victory State Bank	4/344522 C&D Order 7/18/98	4/344522 PCA 11/6/98			
Bank of Honolulu	MOU 4/97	3/333423 2nd MOU 6/98	4/344433 (V)* section 8(g) Suspension & Removal Order 12/18/98	5/455543 C&D Order 1/10/99	5/555555 PCA 8/4/00
Bank of Alamo	3/233232 MOU 11/8/99	3/233132 2nd MOU 9/26/00	4/344322 C&D 2/4/02	5/555555 Emergency C&D 8/27/02	5/555555 PCA 8/29/02
Salt Lick Deposit Bank	4/344333 Safety & Soundness Plan 2/18/01	5/555533 Proposed C&D** 2/28/01	5/555533 PCA*** 4/17/01		
Bank of Sierra Blanca	2/123232 State Commitment Letter 6/25/98	4/455432 C&D 5/3/00	5/555555 PCA 8/16/00	5/553553 PCA 5/17/01	5/554555 PCA 11/20/01
Home State Bank	5/555543 C&D 2/4/00	5/555543 PCA 5/16/00	5/555554 PCA 9/27/00		
First Alliance Bank & Trust	4/324443 C&D 10/8/98	4/434432 2nd C&D 9/6/99	5/535542 PCA 7/6/00	5/535542 PCA 8/4/00	5/535542 PCA 1/4/01
Open Bank #2	3/233231 MOU 2/19/98	3/433131 Board Resolution 4/27/99	2/232121 Revised Board Resolution 10/27/99	4/454442 PCA 12/31/01	4/454442 C&D 5/15/02

Source: OIG analysis of institutions in which PCA directives were used.
* (V) Visitation
** The bank refused to stipulate to the C&D Order. See discussion that follows.
*** The bank appealed the PCA directive on 4/30/01.

The supervisory actions taken in advance of PCA directives included capital-related provisions similar to those that are mandated under section 38, demonstrating the flexibility of these supervisory tools as well as the regulators' awareness of the developing problems related to capital conditions. Supervisory actions, both MOUs and C&Ds, contained section 38-type provisions for seven of eight banks listed in Table 3 for which the FDIC used the PCA directives. Specific capital-related provisions in supervisory actions taken prior to PCA directives follow:

- Maintenance of Tier 1 capital at or above the threshold for the "well capitalized" category.
- Requirements to submit capital plans and abide by any conditions stipulated within the plans.
- Prohibitions against declaring dividends without the FDIC's consent.

While sections 38 and 39 are a valuable part of DSC's financial institution supervision/enforcement processes, similar, if not the same results can be achieved through the use of various provisions of section 8 of the FDI Act. Relevant provisions include the termination of insurance, cease and desist actions, temporary cease and desist actions, and suspension and removal actions. Because of the broader scope of corrective actions achieved by use of section 8(b), DSC more commonly utilizes section 8(b) in addressing problem institution situations. Section 8(b) orders typically include provisions covering the various requirements and limitations of section 38, even when the subject institution would not otherwise be subject to the PCA enforcement framework.

Source: FDIC Division of Supervision and Consumer Protection

PCA is most effective in the circumstances in which an institution is already within a capital category that allows for the issuance of a PCA directive and where the problems to be addressed are essentially capital driven. When the institution's problems include other issues, such as the need to cease violations or correct unsafe or unsound practices or for affirmative relief, other enforcement remedies--cease and desist orders, for example--are more appropriate. Experience has been that while PCA should be "prompt," it is often as quick to get a cease and desist or other order by consent in as little time, with broader relief. In addition, the FDIC is not constrained by the requirements of PCA regarding capital levels when pursuing cease and desist actions.

Source: FDIC Legal Division

FACTORS IMPACTING THE EFFECTIVENESS OF SECTION 38 CAPITAL-RELATED PROVISIONS

During our review, we observed that a number of factors impact the effectiveness of PCA provisions. The foundation of section 38 is capital, which can be a lagging indicator of an institution's operational and financial problems. In addition, use of PCA directives depends on the accuracy of capital ratios reported in Call Reports. However, we noted that capital ratios reported in Call Reports are not always reliable. Further, institutions increased their capital before or after issuance of PCA directives. Finally, risks related to subprime loans are not accounted for in the current method of computing capital. All of these factors delay the use of PCA directives.

Capital Can Be a Lagging Indicator

Section 38 has an inherent limitation because the foundation for its provisions is capital, which can be a lagging indicator of an institution's operational and financial health. Traditionally, capital has been a focus of regulatory oversight because it provides an important cushion to absorb an institution's losses. Although capital is an objective measure of financial health, it may not show signs of decline until a bank has experienced substantial deterioration in its operations. Problems related to an institution's asset quality, management, and internal controls can occur years before capital is adversely affected. As we discussed earlier, capital is the centerpiece of section 38 provisions, and the actions provided for under that section are tied to declining capital levels.

Our review of the eight institutions for which the FDIC issued PCA directives showed that, in all cases, one or more examinations revealed deteriorating conditions in various aspects of bank operations before capital began to deteriorate. Because the problems identified were initially unrelated to capital, the FDIC took other supervisory actions to address those problems. For purposes of our analysis, we defined the onset of problems in an institution when the bank's CAMELS composite rating was first determined to be a 3, 4, or 5. Seven of the eight banks were considered to be well capitalized when they were initially assigned composite ratings of 3 or worse. Consequently, there is usually a time lag between the initial identification of a bank's problems and issuance of PCA directives. Table 4 shows the eight institutions and the problems identified by examiners, their capital category at the time problems were identified, whether other supervisory actions were taken prior to PCA, and the time between the initial identification of problems and subsequent issuance of PCA directives.

Table 4: Analysis of Problems Identified, Capital Categories, Supervisory Actions, and Time Lapse Between Identification of Problems and PCA Directives

	Initial Identification of Problems				
Name	**Asset Quality Problems**	**Problems Related to Management & Internal Controls**	**Capital Category When Problems Were Initially Identified**	**Other Supervisory Actions Prior to PCA**	**Time Between CAMELS 3, 4, or 5 and PCA Directive***
Victory State Bank	Yes	Yes	Well	Yes	1.5 years
Bank of Honolulu	Yes	Yes	Well	Yes	9 years
Bank of Alamo	Yes	Yes	Well	Yes	3 years
Salt Lick Deposit Bank	Yes	Yes	Well	Yes	1 year
Bank of Sierra Blanca	Yes	Yes	Well	Yes	1.5 years
Home State Bank	Yes	Yes	Under	Yes	1 year
First Alliance Bank & Trust	Yes	Yes	Well	Yes	2.5 years
Open Bank #2	Yes	Yes	Well	Yes	3.5 years

Source: OIG analysis of institutions in which the FDIC issued a PCA directive.
*This information was computed using the date for which the examiners assigned a composite rating of 3, 4, or 5 for the first time and the date of the first PCA directive.

In reviewing the eight banks for which PCA directives were used, we observed that in all cases, the examiners identified deteriorating asset quality, which resulted from deficiencies related to bank management and/or board oversight. Examiners identified the following examples of deficiencies related to deteriorating asset quality:

- problems related to one person dominating the institution,
- weak or inadequate board oversight,
- insider lending or related abuses, and
- lack of expertise and/or qualified personnel.

Although Open Banks # 1 and # 3 were not subject to PCA directives, their component ratings for capital were 3 and 5, respectively (see Tables 7 and 6). Although examiners also identified problems related to management and/or board oversight for these two banks, the problems were due to the control exercised by their holding companies. These types of deficiencies, with specific examples taken from our case studies, are discussed in Appendix IV of the report.

Capital Ratios Reported in Call Reports Are Not Always Reliable

The capital ratios reported by institutions in their Call Reports did not always reflect actual financial conditions. Specifically, for 9 of the 11 banks that we reviewed, we observed that during examinations, the FDIC lowered the capital categories reported by the banks in Call Reports by one or more levels. In addition, two earlier reports that we issued pointed out problems with the valuation of assets and the delay in determining the fair value of assets and the appropriate capital category for implementing PCA provisions.[9] The institutions report their capital ratios every 3 months in their Call Reports. However, apart from some edits and validation checks, the FDIC verifies the accuracy of the information submitted in Call Reports only during examinations.

Consequently, depending on whether an institution's examination cycle is 12 or 18 months, erroneous or intentionally misleading financial information may go undetected by the regulators for a period of a year or more. During the time between examinations, an institution that is experiencing worsening financial or operational problems may be successful in forestalling capital-driven regulatory actions by submitting overly optimistic or inaccurate information, thereby postponing the initiation of PCA directives.

The FDIC verifies the accuracy of information reported by institutions during examinations or special visitations. Under Section 7 of the FDI Act, codified to 12 U.S.C. §1817, FDIC-supervised institutions submit quarterly Call Reports to the FDIC. The accuracy of a bank's capital ratios is based on the fair value of its assets, an assessment of the risks in a bank's portfolio as judged by its managers, and the adequacy of a bank's ALLL. During the past few years, there have been repeated instances where troubled institutions did not fully disclose their true financial condition in Call Report information. The consequences of these situations have been large losses to the insurance funds.

- We concluded in our March 2002 report on the effectiveness of PCA that, in the cases of Superior Bank, First National Bank of Keystone, and Pacific Thrift & Loan Company, PCA provisions had not been implemented in a timely manner. All three institutions had a high concentration of residual assets and either valued those assets using optimistic assumptions and/or failed to discount future cash flows that inflated the institutions' income and capital. Therefore, the capital levels for those three

[9] FDIC OIG Audit Report No. 02-013, *The Effectiveness of Prompt Corrective Action Provisions in Preventing or Reducing Losses to the Deposit Insurance Funds*, dated March 26, 2002, and Audit Report No. 03-017, *Material Loss Review of the Failure of the Connecticut Bank of Commerce, Stamford, Connecticut*, dated March 10, 2003.

institutions were above the minimum levels required by the regulators to invoke section 38 actions because a fair value of the residuals had not been determined.[10]

- Our review of the failure of the Connecticut Bank of Commerce (CBC) showed that in December 1996, the bank's capital category reached an acceptable position of "adequately capitalized" and remained in this category until 1999, when it became "well-capitalized." Because CBC masked the true nature of certain financial transactions, examiners did not determine its actual financial condition until a full investigation was performed subsequent to the March 2001 examination. Once the bank's loan schemes were uncovered, the examiners concluded that CBC was critically undercapitalized, and it was closed on June 26, 2002.[11]

In addition, for 9 of the 11 banks reviewed, we noted instances where the capital categories reported by the banks in their Call Reports overstated the banks' actual capital conditions. This observation is based on our comparison of capital ratios reported by the banks in their Call Reports with ratios developed by examiners during examinations for corresponding periods. Table 5 shows the 9 institutions for which examiners lowered the capital category.

[10] FDIC OIG Audit Report No. 02-013, entitled *The Effectiveness of Prompt Corrective Action Provisions in Preventing or Reducing Losses to the Deposit Insurance Funds,* dated March 26, 2002. On November 29, 2001, federal regulators issued Financial Institution Letter 99-01 entitled "Final Rule to Amend the Regulatory Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, Residual Interests in Asset Securitizations, and Asset Backed and Mortgage-Backed Securities," which addressed the capital requirements for residual assets.

[11] FDIC OIG Audit Report No. 03-017, entitled *Material Loss Review of the Failure of the Connecticut Bank of Commerce, Stamford, Connecticut,* dated March 10, 2003.

Table 5: Institutions for Which Examiners Lowered Capital Categories

Name	Call Report Date	Capital Category Reported by Institutions	Capital Category Determined by Examiners
Victory State Bank	9/30/98	Undercapitalized	Critically Undercapitalized
Bank of Honolulu	9/30/98	Well Capitalized	Adequately Capitalized
	6/30/00	Well Capitalized	Significantly Undercapitalized
Bank of Alamo	3/31/02	Well Capitalized	Critically Undercapitalized
Bank of Falkner	6/30/00*	Well Capitalized	Critically Undercapitalized
Salt Lick Deposit Bank	12/31/00*	Well Capitalized	Critically Undercapitalized
Bank of Sierra Blanca	6/30/00	Significantly Undercapitalized	Critically Undercapitalized
	12/31/00	Well Capitalized	Undercapitalized
	9/30/01	Undercapitalized	Critically Undercapitalized
Home State Bank	6/30/99	Adequately Capitalized	Undercapitalized
	12/31/99	Adequately Capitalized	Critically Undercapitalized
	6/30/00	Undercapitalized	Critically Undercapitalized
Open Bank # 2	9/30/01	Well Capitalized	Undercapitalized
Open Bank # 3	12/31/01	Well Capitalized	Adequately Capitalized

Source: OIG Analysis of 11 institutions in our sample.
* Examiners used more current data in addition to Call Report data.

We noted that for the Bank of Sierra Blanca and Home State Bank, examiners lowered each bank's capital category on three occasions. The Bank of Honolulu had its capital category reduced twice, and the remaining six banks had their categories lowered once. Most (about 71 percent) of the downward revisions in capital categories in our sample involved lowering a bank's category two or more levels. Notably, the capital categories for the Bank of Alamo, Bank of Falkner, and Salt Lick Bank were reduced to the maximum extent possible, four levels – from "well-capitalized" to "critically undercapitalized."

Institutions May Delay Implementation of PCA Directives or Closure by Increasing Capital

During our review, we determined that several institutions increased their capital before or after issuance of PCA directives, thereby delaying implementation of the directives or, in some cases, closure. Institutions or their holding companies used various ways to increase capital, including selling assets, transferring income from another affiliate, contributing in-kind capital, and injecting capital in cash. These forms of capital infusion are accepted industry practices, and additional capital strengthens the financial condition of institutions. The infusions, nevertheless, can delay the initiation of PCA directives or raise capital levels above capital thresholds, causing PCA directives to be withdrawn without correcting the underlying problems at the institutions.

Sale of Assets: The Bank of Honolulu serves as an example of an institution in our sample that sold assets to increase its capital ratios before PCA directives were issued. The bank had not achieved a CAMELS composite rating better than a "3" since its September 30, 1991 joint examination. In two examinations and a visitation occurring between January 1999 and January 2000, examiners noted that the Bank of Honolulu maintained its capital through asset shrinkage. In other words, the bank sold assets to increase its capital. This bank's capital category was adequately capitalized during the January 1999 examination, the following visit in June 1999, and an examination in January 2000. The FDIC issued a PCA directive in August 2000 when the FDIC determined the bank's capital level to be "significantly undercapitalized."

Transfer of Income from Affiliate: In Open Bank # 1, one of the three open banks in our sample, the examiners noted that the bank benefited from a transfer of income from an affiliate owned by the institution's parent. In fact, the examination report stated:

> High earnings are, in part, due to transfer of income from affiliates. For example, [Open Bank # 1] received $73 million in mortgage servicing income in 1999. However, this bank does not perform any servicing and has minimal involvement in the programs. ... This example illustrates that earnings of the bank are dependent on the parent's policy for allocating earnings among subsidiaries. Currently, [Open Bank # 1] is the beneficiary of the parent's policy.

Even after the transfer of such a substantial amount, Open Bank # 1 reported a net income of just $48.6 million for 1999. Additionally, examiners determined that net income was overstated by approximately $12.5 million because of (1) inappropriate recognition of $4 million in income, (2) failure to recognize $4 million in operating losses, and (3) underfunding of the ALLL by approximately $4.5 million.

Assuming that the $73 million transfer of income was not made, the institution would have incurred a net loss of $36.9 million, computed as follows:

Reported net income	$48.6 million
Less: Operating losses not recognized	(4.0 million)
Income inappropriately recognized	(4.0 million)
Underfunded ALLL	4.5 million)
Net income before adjustment for transfer of income from affiliate	36.1 million
Less: Transfer of income from affiliate	(73.0 million)
Net Loss	($36.9 million)

This example illustrates how a parent company radically changed the financial results of its subsidiary institution from a loss of $36.9 million in 1 year to a net income of $48.6 million, through a transfer of income from an affiliate. In addition, the parent contributed capital in-kind, discussed below, which further increased the institution's capital. Without the transfer of income and contribution of in-kind capital, it is likely that this institution would have been subject to a PCA directive.

> This affiliate transaction was considered a form of parent company support for the financial institution. Had the income from the affiliate not transferred, it would have required another form of parent company support to support growth, such as a direct capital injection.
>
> DSC further clarified that the bank included the transferred income in its reported income in the Call Report. This transfer should not have been reported as income on the Call Report. The FDIC has long taken the position that income transfers by a holding company to a bank should be reported as capital contributions. Banks should not report in income any income that arose from assets owned by an affiliate (other than its own subsidiary) or was otherwise generated by an affiliate that its parent company transfers to it. Otherwise, the parent company could conceivably make the bank's earnings be any number the parent wanted it to be.
>
> Source: FDIC Division of Supervision and Consumer Protection

In-Kind Capital Contribution: Open Bank # 1 was also the beneficiary of an in-kind capital contribution made by its parent. During 1999, this bank's capital level was less than satisfactory. In response, Open Bank # 1's parent made an in-kind contribution from two of its subsidiaries into the bank, representing a contribution of $41.5 million. This amount included $38.2 million in assets from one of the parent's subsidiaries and consisted of a Class C retained interest on credit card securitizations. The assets were contributed at book value without an independent market value appraisal. The remaining $3.3 million consisted of computer software and office equipment owned by another subsidiary of the parent, which was also contributed without an independent market value appraisal. This subsidiary continued to use these assets without reimbursing the bank.

These examples of transfers from affiliates clearly illustrate how a parent holding company can manipulate the net income and capital levels of a bank to prevent or delay the implementation of PCA directives.

> This affiliate transaction was considered a form of parent company support for the financial institution. Had the in-kind contribution not been made, it would have required another form of parent company support to support growth, such as a direct capital injection.
>
> Source: FDIC Division of Supervision and Consumer Protection

Contribution of Capital After a PCA Directive: Based on a review of the Bank of Sierra Blanca's June 30, 2000 Call Report, the FDIC determined the bank to be significantly undercapitalized. The FDIC issued a PCA directive to the bank in August 2000. The bank's directors then made three capital injections between October 2000 and June 2001. Initially, the directors made a capital injection of $514,000 in October 2000. The directors injected an additional $301,000 in November 2000. These two capital injections improved the bank's capital position, and the bank reported itself well capitalized as of December 31, 2000.

In April 2001, the state conducted an examination and again determined the bank's capital level to be undercapitalized. In June 2001, the directors injected an additional $100,000 of capital, and the bank became adequately capitalized. However, anticipated

loan loss recoveries did not materialize for the bank, and in November 2001, the FDIC notified the bank's board that the bank was critically undercapitalized. On January 17, 2002, the FDIC and the state met with the board and directed an injection of $1.5 million in new capital, which the board was unable to meet. The state closed the bank the next day.

> Capital contributions (either directly or indirectly through the transfer of income from an affiliate) are almost always good for the FDIC—even if the institution ultimately fails. Capital contributions increase the probability that the institution will survive and reduce FDIC losses in the event of failure.
>
> Source: FDIC Division of Supervision and Consumer Protection

We agree that capital contributions will almost always serve to protect the insurance funds. However, such contributions in the form of sales of assets or in-kind capital contributions without independent valuations may not always serve to prevent or reduce losses to the insurance funds. For example, an institution may sell its quality income producing assets to bring in additional capital, thus delaying the use of PCA directives and/or closure. Also, with in-kind contributions, the quality of the contributions may be suspect if bank management does not independently value these assets. In both cases, the transactions delay closure, and remaining assets may deteriorate further, resulting in additional losses to the insurance funds.

Risks Related to Subprime Loans Are Not Accounted for in the Current Method of Computing Capital

The current method of computing capital does not take into account risks related to subprime loans. Specifically, the federal banking regulators currently do not require institutions in their Call Reports to risk-weight subprime loans commensurate with the risks associated with those loans. Consequently, the capital ratios reported in Call Reports for those institutions may be inflated, thus delaying the initiation of PCA directives in banks that are experiencing problems.

The FDIC collects, corrects, updates, and stores Call Reports submitted by institutions it supervises on a quarterly basis. Call Reports are a widely used source of financial data regarding a bank's condition and the results of its operations. Under the banking agencies' risk-based capital guidelines, assets and credit equivalent amounts of derivatives and off-balance sheet items are assigned to one of several broad risk categories according to obligor, or, if relevant, the guarantor or the nature of the collateral. The resulting weighted values from each of the risk categories are added together, and this sum is the bank's total risk-weighted assets, which comprises the denominator of the risk-based capital ratio. The risk-weights associated with each asset are included in Schedule RC-R – Regulatory Capital, which is part of the Call Report.

All three open institutions in our sample had subprime loans in their portfolio. As early as 1997, regulators were cautioning financial institutions regarding the potential risk associated with subprime lending. However, there are no federal laws, regulations, or

rules concerning subprime lending. In March 1999, the Federal Financial Institutions Examination Council (FFIEC)[12] issued the *Interagency Guidelines on Subprime Lending*. The guidelines defined subprime lending as "extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers" and required regulators to evaluate the capital levels at examinations of banks engaged in subprime lending.[13] In January 2001, the FFIEC issued *Expanded Guidance for Evaluating Subprime Lending Programs* (Expanded Guidance). This Expanded Guidance supplements the FFIEC guidelines issued in March 1999 and is specifically tailored to institutions that have subprime lending programs with an aggregate exposure greater than or equal to 25 percent of Tier 1 Capital. The Expanded Guidance states that because subprime lending poses more risk than standard lending, it is expected that capital levels would be at minimum one and a half to three times greater than what is appropriate for non-subprime assets of a similar type.[14]

Because of concerns relating to risks posed by subprime loans, and in an attempt to identify additional sources of information related to subprime lending programs at FDIC-insured institutions, the regulators proposed changes to the Call Report. On May 31, 2000, the federal banking agencies published a notice for comment regarding the inclusion of additional reporting items in the Call Report for subprime lending activities. However, on December 9, 2002, the FFIEC voted to drop the proposal due to responses from the industry and Congress. In making the decision to drop the proposal, the agencies agreed with commenters that the industry lacks standard definitions for the terms "subprime" and "program." Thus, rather than impose an additional burden on institutions through the proposed regulatory reporting requirement, the agencies concluded that the examination process should continue to be the focal point for supervising the subprime lending activities of banks and savings associations. Consequently, under the current method of reporting, institutions do not risk-weight subprime loans in their Call Reports as suggested by the Expanded Guidance, resulting in inflated capital ratios that may delay initiation of a PCA directive.

Because the FFIEC decided not to require banks to use the higher risk weighting for subprime loans in Call Reports and compliance with the Expanded Guidance is voluntary, the FDIC cannot enforce the risk-weighting of subprime loans during examinations. As a result, we observed a wide disparity between capital adequacy as reported in the Call Reports and examiners' CAMELS ratings. We also observed that examination reports generally criticize institutions for non-compliance with the Expanded Guidance and inadequate capital in relation to the risks associated with subprime loans.

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[12] The FFIEC was established by the Congress to promote improved and consistent examination and supervision policies and procedures among the five financial institution regulatory agencies. The FFIEC includes representatives of the FDIC, FRB, OCC, OTS, and National Credit Union Administration (NCUA).

[13] The FDI Act, Section 10(d), requires the appropriate federal banking agency to conduct annual full-scope, on-site examinations of each insured depository institution.

[14] Potential long-term risks are protected against through higher capital requirements. ALLL absorb credit losses, in the short term, over the current operating cycle, typically 12 months in accordance with the Interagency Policy Statement on the ALLL, dated December 21, 1993.

Since the issuance of the Expanded Guidance in January 2001, examiners conducted two examinations in Open Banks # 3 and # 1--banks that had subprime loans in their portfolios. Information and comments from examination reports are provided below:

Table 6: Information from Two Examinations of Open Bank # 3

Examination Start Date	Examination as of Date	Assets/Deposits (in billions)	Capital Category per Call Report	Capital Category Determined by Examiners	CAMELS Rating
9/2001	12/31/2001*	$2.1/1.9	Well	Adequate	5/555544
11/2002	9/30/2002	$1.85/1.67	Well	Well	5/555434

Source: OIG analysis of examination reports of Open Bank # 3.
* Because of significant deterioration identified during the examination, the examiners decided to use the December 2001 financial information.

Although Open Bank # 3 received the worst possible rating for its capital component in two consecutive examinations, its capital category for PCA purposes was "adequately capitalized" and "well capitalized" during those examinations. However, the first examination report stated that the institution had not implemented the Expanded Guidance and that capital levels were inadequate under the Expanded Guidance. The second examination report stated that capital was insufficient for the institution's high-risk profile and that the institution did not comply with the Expanded Guidance. Similar observations were noted in the examination reports of Open Bank # 1.

Table 7: Information from Two Examinations of Open Bank # 1

Examination Start Date	Examination as of Date	Assets/Deposits (in billions)	Capital Category per Call Report	Capital Category Determined by Examiners	CAMELS Rating
4/2001	3/31/2001	$1.0/0.7	Well	Well	3/333322
5/2002	3/31/2002	$0.9/0.7	Well	Well	3/333333

Source: OIG analysis of examination reports of Open Bank # 1.

The first examination report stated that although the bank was considered "well capitalized" for PCA purposes, the above-average risk in loan and lease portfolios demonstrated the need for higher capital. The report also stated that the institution had not followed the Expanded Guidance. The second examination report stated that the capital was marginally deficient to support the overall risk profile of the institution and that the institution did not comply with the FFIEC Expanded Guidance.

While the FDIC criticized Open Banks # 3 and # 1 for their capital inadequacy and non-compliance with the Expanded Guidance, it chose to enforce only the higher capital provisions included in the Expanded Guidance in Open Bank # 2. The FDIC examined this bank in November 2001 and determined that it was "undercapitalized" as of September 30, 2001, although the bank was "well capitalized" as reported in the Call

Report. As of that date, the total assets and deposits were $1.92 billion and $1.42 billion, respectively. The CAMELS rating assigned during this examination was 4/454442. Subsequently, in May 2002, the FDIC issued and the bank consented to a Cease and Desist order that included the following provision:

> Submission of a capital plan to achieve/maintain an 8 percent Total Risk-based capital ratio based on 300 percent risk-weighting of loans, by September 30, 2002 and a 10 percent Total Risk-based capital ratio by March 31, 2003.

By including this provision in the Cease and Desist Order, the FDIC effectively made the higher risk-weighting for subprime loans a formal requirement although use of risk weighting is only a guideline for the institutions and the examiners. It is not clear, however, why this same strategy was not used in the other two open institutions.

The three open banks in our sample show the wide disparity between capital levels reported by banks in their Call Reports and by examiners in CAMELS ratings or examination comments on capital adequacy. In addition, the three banks show an apparent inconsistency in how DSC officials applied the risk-weighting provision of the Expanded Guidance at these three institutions. Although we reviewed only 3 open institutions with subprime assets, as of December 31, 2002, 125 FDIC-insured institutions had $53.8 billion in subprime assets. The magnitude of the number of institutions and total value of subprime assets points to the need to better monitor the capital adequacy reported in Call Reports and to consistently apply the provision in the Expanded Guidance during examinations. However, as long as the provision for higher risk weighting for subprime loans is not a requirement and is not reported in the Call Reports, identification of capital inadequacy may be difficult to achieve between examinations or during examinations.

In the Financial Institution Letter (99-01) sent to institutions entitled "Final Rule to Amend the Regulatory Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, Residual Interests in Asset Securitizations, and Asset-Backed and Mortgage-Backed Securities" dated November 29, 2001, federal banking regulators changed the regulatory capital standards to address the treatment of the above-mentioned instruments, and provided each regulatory agency with the reservation of authority to modify a stated risk-weight or credit-conversion factor on a case-by-case basis. The effective date of this final rule was January 1, 2002, but under certain circumstances, implementation could be delayed to December 31, 2002. Under the new rule, the Director of the Division of Supervision and Consumer Protection may, on a case-by-case basis, determine the appropriate risk weight for any asset or credit equivalent amount that does not fit wholly within one of the risk categories set forth in Appendix A of Part 325 of the FDIC Regulations, or that imposes risks on a bank that are not commensurate with the risk weight otherwise specified in Appendix A for the asset or credit equivalent amount.

The Legal Division has opined that such a determination should not be made prior to the December 31, 2002, final implementation date of the rule. Consequently, while higher risk weights were used in the C&D of Open Bank # 2 and in the examination evaluation of capital adequacy, no higher risk weights were used for PCA calculations.

Source: FDIC Division of Supervision and Consumer Protection

With regard to DSC's comments above, under Financial Institution Letter 99-01, the Director of DSC can determine on a case-by-case basis the risk weights of assets that do not fit wholly within one of the risk categories set forth in Appendix A of Part 325 of the FDIC Regulations, codified to 12 C.F.R. part 325. However, application of this provision on a case-by-case basis may result in inconsistent application of this rule as was demonstrated with regard to Open Bank # 2 and the other two open banks. Further, an important benefit of the Call Report, which is early detection of capital adequacy problems between examinations, is not achieved if the institutions are not required to report subprime loans on a risk-weighted basis as suggested in the Expanded Guidance.

Conclusion

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. Section 38 and 39 provisions were originally enacted to limit regulatory discretion in key areas and to mandate regulatory responses against financial institutions with safety and soundness problems. With respect to the the capital-related provisions of section 38, our review of 11 FDIC-supervised institutions disclosed that PCA directives were part of the enforcement process and prevented or reduced losses to the deposit insurance funds.

Our audit results point to several factors that can limit the effectiveness of section 38 capital-related provisions – capital being a lagging indicator, unreliable Call Report data, transactions that increase capital before or after PCA directives are issued, and the inadequate accounting for risk associated with subprime loans. With respect to capital being a lagging indicator, we propose several options later in this report to strengthen the non-capital related provisions of PCA to mitigate this inherent weakness in PCA. Regarding unreliable Call Report data, the limitations of such data have been well documented and, to date, a solution outside of examiners reviewing the data against their examination results has not emerged, which emphasizes the critical need for timely and periodic on-site examinations. Also, capital infusions that occur before and after PCA directives are issued are to be expected, and we can only offer that the source of those infusions must be analyzed carefully to ensure the transactions actually improve rather than mask the health of the institution. Analyzing capital infusions will help prevent undue forbearance by regulators. Finally, inadequate accounting for risk associated with subprime loans in Call Reports can be mitigated through revised reporting requirements. Such additional information would improve the FDIC's ability to detect capital deficiencies.

SECTION 38 AND 39 NON-CAPITAL-RELATED PROVISIONS

NON-CAPITAL-RELATED PROVISIONS WERE SELDOM USED

From our review of 11 institutions, we observed that the FDIC seldom used the non-capital provisions of PCA. Although the primary focus of section 38 is capital, sections 38 and 39 provide for certain actions based on non-capital factors to facilitate issuance of PCA directives or to address a non-capital problem. Specifically, section 38(g) provides for reclassification of the capital category of institutions based on non-capital factors. Also, section 38(f)(2)(F) provides for regulatory agencies to require an institution to improve management when regulators consider management to be deficient. Finally, section 39 provides for regulators to require a compliance plan from institutions when they identify problems with (1) operations and management; (2) asset quality, earnings, and stock valuation; and (3) compensation.

Reclassification of Capital Category Based on Non-capital Factors

The FDIC did not use section 38(g) in any of the 11 institutions that we reviewed even though opportunities were present at 10 institutions to implement this provision. The remaining institution was closed immediately without a PCA directive after a fraud scheme was discovered. Section 38(g) provides regulators a means to take prompt corrective action based on criteria other than capital. Specifically, the regulators can downgrade an institution by one capital level if an institution is in an unsafe and unsound condition or is engaged in unsafe and unsound practices. For example, the regulators could downgrade an adequately capitalized institution to the undercapitalized category and require the institution to comply with the restrictions applicable to that category, such as limits on the institution's growth. However, the implementing regulation for section 38(g) is vague and does not provide a clear trigger for implementing this provision. In addition, this provision and the implementing regulation place additional restrictions on use of the provision.

The implementing regulation for section 38(g) is contained in section 325.103 of the FDIC Regulations, codified to 12 C.F.R. 325.103. This section states:

> *Reclassifications based on supervisory criteria other than capital.* The FDIC may reclassify a well capitalized bank as adequately capitalized and may require an adequately capitalized bank or an undercapitalized bank to comply with certain mandatory or discretionary supervisory actions as if the bank were in the next lower capital category (except that the FDIC may not reclassify a significantly undercapitalized bank as critically undercapitalized) (each of these actions are hereinafter referred to generally as "reclassifications") in the following circumstances:
> (1) *Unsafe or unsound condition.* The FDIC has determined, after notice and opportunity for hearing pursuant to § 308.202(a) of this chapter, that the bank is in unsafe or unsound condition; or

> (2) *Unsafe or unsound practice*. The FDIC has determined, after notice and opportunity for hearing pursuant to § 308.202(a) of this chapter, that, in the most recent examination of the bank, the bank received and has not corrected a less-than-satisfactory rating for any of the categories of asset quality, management, earnings, or liquidity.

As can be seen, this section of the regulation provides for two situations when an institution's capital category can be reclassified. However, both situations require judgment on the FDIC's part before this provision can be implemented. The first situation requires judgment as to when the FDIC considers an institution to be in an unsafe and unsound condition. Although the second situation provides an objective measure—the CAMELS rating assigned during examinations—for the purpose of reclassifying an institution to the next lower capital category, it is still subjective in that this section does not define a "less-than-satisfactory" rating. Consequently, section 38(g) does not provide objective criteria for implementation and does not clearly state when this provision can be used. Based on our review of 11 FDIC institutions, using a composite rating of 4 or lower as the criteria, we determined that the FDIC could have reclassified 10 of the 11 institutions to the next lower capital category, but did not do so.

> Section 38(g) criteria for "reclassification" includes that the appropriate banking agency may deem the institution to be engaging in an unsafe and unsound banking practice, a matter with which the banking agencies have significant experience. Absent other available enforcement vehicles, the agencies would no doubt utilize section 38(g) more often to "reclassify" troubled institutions. However, enforcement authority under section 8(b) of the FDI Act is also premised on unsafe and unsound banking practices. A major consideration here is that mandatory actions triggered by non-capital criteria under an enhanced PCA framework would likely be duplicative of those imposed otherwise under a more comprehensive section 8 enforcement action.
>
> Source: FDIC Division of Supervision and Consumer Protection

In addition to not providing objective criteria, this provision also imposes several restrictions on its implementation. For the FDIC to implement this section, it is required to provide the institution with a notice and an opportunity for hearing in accordance with section 308.202-*Procedures for reclassifying a bank based on criteria other than capital* of the FDIC regulations, codified to 12 C.F.R. 325.202. A review of this section of the regulation indicates that the FDIC is required to provide prior notice to the institution, allow the institution to file a written response to the notice, allow the institution to request a hearing and present oral testimony or witness, order an informal hearing, and designate a hearing officer. In addition, this section describes hearing procedures and allows for a request for rescission of reclassification by the institution when circumstances change. The lack of objective criteria and these restrictions make the implementation of the reclassification provision very difficult.

To reclassify an institution, we must determine, after a notice and hearing that an institution is in an unsafe or unsound condition or is engaging in an unsafe or unsound practice under section 8(b)(8)--which requires that an institution receive in its most recent examination a less than satisfactory rating for asset quality, management, earnings, or liquidity. If we meet that test, then the FDIC issues a written notice of intent to reclassify. The bank may respond to the notice within the time period set by the FDIC, which is 14 days (unless the FDIC sets a shorter period). Failure to respond to a notice within the specified time period constitutes a waiver of the right to respond and consent to the reclassification. The bank may request an informal hearing before designated FDIC officials to contest the proposed reclassification. The FDIC will order the hearing to commence within 30 days or receipt of the request. The bank can introduce written testimony and oral argument, although introduction of oral testimony and witnesses is at the discretion of the hearing officer. Within 20 days of the hearing and closing of the record, the presiding officer must make a recommendation to the FDIC regarding reclassification. Within 60 days of closing the record or, if there was no hearing, the date the response was received, the FDIC has to make a decision on the reclassification. This process saves little time and may require a substantial cost burden for litigation, albeit informal litigation.

An additional issue is what happens when an institution's capital category rises before the process of issuing a directive is complete, or after the directive is issued. Banks can subsequently request that a reclassification be rescinded and any directives issued in connection with the reclassification be modified, rescinded, or removed upon a change in circumstances.

Thus the requirement that an institution be in a particular capital category has at times been a problem. In instances in which an institution is well capitalized or adequately capitalized, PCA does not provide a full remedy. Getting an institution reclassified to a level that allows us to take the action we need is often a difficult and lengthy process. In addition, we only can obtain one level of downgrading through this process.

Source: FDIC Legal Division

Improving Management

During our review, we observed that for 2 of 11 institutions, the FDIC issued a "Notice of Intent to Issue a Prompt Corrective Directive Ordering Dismissal." Although opportunities for similar actions were present in four other institutions, the FDIC did not initiate this action. Section 38(f)(2)(F) provides that once an institution reaches the "significantly undercapitalized" capital category, the regulators can initiate action to improve management by requiring the board to take one of the following actions:

- Ordering a new election for the institution's board of directors.
- Requiring the dismissal of directors or senior executive officers.
- Requiring the employment of qualified senior executive officers.

Of the eight failed or acquired institutions in our sample, six reached the "significantly undercapitalized" capital category or worse. The FDIC used the authority provided by section 38(f)(2)(F) in the following two cases.

- In the case of Victory State Bank, the examiners noted that the bank's condition was continuing to deteriorate as a result of the Chairman's detrimental influence. The examiners cited the main cause as the Chairman's excessive compensation. In addition, underwriting and credit administration practices were weak. The FDIC issued a "Notice of Intent to Issue a Prompt Corrective Directive Ordering Dismissal" of the Chairman on March 5, 1999, and the bank was closed on March 26, 1999.

- In the case of Bank of Alamo, the problems started with the Chairman of the Board, who had very little experience managing a bank. After gaining control of the institution, he appointed unqualified or inexperienced personnel to run the bank. Additionally, he entered into personal business relationships that he did not divulge to the board or to the examiners. Under his control, the bank extended a $4.23 million line of credit (approximately 76 percent of Tier 1 capital) that was broken into several smaller credits to conceal violations of state legal lending limits. The bank also extended another poorly structured and poorly documented $1.5 million credit to another borrower. When these two loans, along with other loans, became delinquent, the bank's capital became deficient. The FDIC issued a "Notice of Intent to Issue a Prompt Corrective Directive Ordering Dismissal" on October 18, 2002, and the Chairman of the Board resigned on October 28, 2002. The bank was closed on November 8, 2002.

Four other institutions' capital reached the "significantly undercapitalized" level. In all four cases, the FDIC did not initiate action under this section even though the banks' management was considered inadequate. For example, in the case of First Alliance Bank and Trust, the bank reached the "significantly undercapitalized" capital category as of June 30, 2000. Examiners noted that, in addition to lacking technical expertise, management either failed to develop policies and procedures or failed to follow those that were developed. Management and the board also allowed the bank to deviate from its business plan, losses were higher than projected because of poorly conceived business lines, no strategic plan had been developed, and disagreements and dissention persisted because of constant turnover on the board and within top management.

The two banks—Victory State Bank and Bank of Alamo--for which the FDIC used this provision, were closed within a month after the dismissal action was taken. As we have demonstrated earlier, capital is a lagging indicator, and capital can remain in the "well to adequate" range long after deterioration has begun in a bank's operations and/or finances. Because section 38(f)(2) allows regulators to take actions to improve management only after an institution reaches the "significantly undercapitalized" category, by the time the actions are initiated, they may have only marginal effect in improving management or the institution.

> With regard to actions against individuals, PCA has lesser standards than section 8(e) removal actions, but the relief is not as broad. PCA dismisses an officer from his position while section 8(e) removes any institution-affiliated party from the banking industry. Again, an institution must fall within an appropriate capital category in order for the FDIC to act.
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> Source: FDIC Legal Division

Supervisory Actions Based on Safety and Soundness Standards

Section 39 directs regulatory attention to the non-capital areas of an institution's activities as they pertain to safety and soundness. To limit deposit insurance losses caused by factors other than 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 valuations; and (3) compensation. This section also directs regulators to require a corrective action plan from institutions that fail to meet any of the standards. The FDIC used section 39 in only 1—the Salt Lick Deposit Bank--of the 11 institutions that we reviewed. For the other 10 institutions, the FDIC used other enforcement actions, such as MOUs and C&Ds, even though opportunities were present in some institutions to implement section 39. Our review of the legislative history of section 39 revealed that several provisions in the original legislation were removed to provide discretion to the regulators and, as a result, this section was weakened. In addition, this section lacks objective criteria defining conditions that would trigger regulatory action. The following example shows the FDIC's use of section 39 in the one institution in our sample.

> The FDIC implemented section 39 in the case of the Salt Lick Deposit Bank with little effect. This bank, with total assets of $47 million, had purchased 58 non-rated industrial development bonds (IDBs) with a book value of $9.7 million. These bonds were essentially commercial loans to under-capitalized corporate borrowers. These bonds were not traded readily, so their fair market value was difficult to ascertain. On November 28, 2000, the FDIC issued a notice under section 39 requiring a Safety and Soundness Compliance Plan to review all non-rated assets contained in the investment portfolio and to make the bank's books reflect the market value of each non-rated security. However, before the Safety and Soundness Compliance Plan was accepted, the FDIC issued a C&D on January 18, 2001, that included the same requirements that were in the Safety and Soundness Compliance Plan. An examination conducted in March 2001 classified approximately $4.5 million of the IDBs, causing the bank's capital to drop to the "critically undercapitalized" level. Salt Lick Deposit Bank was acquired by another bank on May 9, 2001.

An analysis of the legislative history indicates that section 39 originally required banking regulators to prescribe safety and soundness standards through regulations. For the operations and management standards, section 39 had required the regulators to prescribe standards on internal control, internal audit systems, loan documentation, credit underwriting, interest rate exposure, and asset growth. For asset quality, earnings, and stock valuation, the section initially required regulators to establish quantitative standards. For compensation standards, the regulators were to specify when compensation, fees, or benefits to executive officers, employees, and directors would be considered excessive or could lead to material financial loss. In addition, another 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.

The Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI), Public Law 103-325, was passed on September 23, 1994, and contained 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 allowed regulators to issue the standards in the form of guidelines instead of regulations. If guidelines were used, the amendments gave the regulators the discretion to decide whether a corrective action plan would be required from institutions that were found not to be in compliance with the standards. Finally, the amendments eliminated the requirement that regulators issue quantitative standards for asset quality and earnings, and excluded holding companies from the scope of the standard.

The CDRI did not change section 39's original provision regarding the content and review of any corrective action plan required as a result of noncompliance with section 39's safety and soundness standards. Thus, regulators still were required to issue regulations governing the contents of the plan, time frames for the submission and review of the plan, and enforcement actions applicable to the failure to submit or implement a required plan.

The banking regulators had not used their section 39 enforcement authority against an institution from inception of the section in December 1991 to September 1996. In July 1995, the regulators issued final guidelines and regulations to implement parts of section 39. Specifically, the regulators issued standards governing operations and management and compensation. Regulators also issued requirements for the submission and review of compliance plans. In August 1996, the regulators issued the remaining standards required for the full implementation of section 39–asset quality and earnings.

The safety and soundness standards contained in the guidelines are general in nature and do not identify specific unsafe and unsound conditions and practices. The standards 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 "an insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets." Specifically, the guidelines require institutions to conduct periodic reviews to identify problem assets, compare problem assets to capital to establish reserves, take appropriate actions, etc. Although these controls and processes are required as part of the standards, these expectations do not provide measurable criteria of unsafe and unsound conditions or practices that would trigger mandatory actions.

Further, the guidelines and regulations do not require regulators to take corrective action against institutions that do not meet the standards for safety and soundness. The CDRI amended the section 39 mandate that regulators require an institution to file a corrective action plan if the institution is found not to be in compliance with the standards. The new

provision allows regulators greater flexibility in deciding when or whether to impose this requirement. Although requiring a corrective action is within the discretion of the regulators, the guidelines do not provide quantifiable criteria or specific guidance for measuring an institution's compliance with section 39 standards or triggering actions under this section.

Although the original intent of section 39 was to limit the deposit insurance losses caused by factors other than capital, subsequent amendments and the discretion provided to regulators substantially weakened this section. In addition, the lack of objective criteria for triggering action and the lack of quantifiable criteria or specific guidance for measuring an institution's compliance with section 39 standards make this section difficult to implement.

> Section 39 is designed to prompt a bank to take steps to identify problems before its safety and soundness becomes impaired. The process involved allows the FDIC to request that a bank file a compliance plan indicating the steps it will take to correct noted deficiencies. The bank is generally given 30 days to file an acceptable compliance plan. The FDIC then has 30 days to consider the bank's plan. If the bank's plan is acceptable, then the FDIC must allow a reasonable time for its implementation. If the plan is unacceptable, the FDIC may issue a Notice of Intention to Issue a section 39 Order directing the bank to correct the deficiency. In most cases, the bank has 14 days to respond. After considering the response, the FDIC may issue an Order. Often the deadlines for correction set forth in the Order will be later than those in the bank's initial plan because of the lapse of time.
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> Thus, Section 39 may be used to correct certain operational deficiencies specified in the guidelines. However, not all deficiencies are covered. Therefore, a section 8(b) cease and desist order, which allows for more flexibility in its areas of coverage, may be necessary. In addition, based upon the facts in a particular case, a consent 8(b) order may be obtained more quickly than section 39 relief given the time frames discussed above.
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> Source: FDIC Legal Division

Conclusion

Sections 38 and 39 provide regulators with non-capital-related enforcement tools that they can use to obtain corrective action or close institutions with serious safety and soundness problems. Specifically, these sections provide for (1) reclassification of a capital category based on non-capital factors, (2) improving management when regulators consider management to be deficient, and (3) supervisory actions based on safety and soundness standards.

Our review disclosed that provisions of sections 38 and 39 do not provide objective, measurable criteria for implementation and in some instances, placed restrictions on their use. Consequently, the non-capital provisions of section 38 and 39 were seldom used.

LEGISLATIVE AND REGULATORY OPTIONS FOR CONSIDERATION

We acknowledge that PCA is one of many supervisory tools and that the FDIC overcame the limitations of sections 38 and 39 through the use of other enforcement actions, such as C&Ds. However, to fulfill the congressional intent and to provide the primary banking regulators with a more effective set of supervisory tools, legislative or regulatory changes may be needed.

Our draft of this report included six recommendations for legislative or regulatory changes to strengthen PCA provisions. However, in discussing the draft report with DSC officials, they stated that the FDIC does not have the authority to unilaterally initiate and enact such changes. In addition, the officials provided various reasons why the Division concluded that adopting the recommendations would not be productive at this time. Details of DSC's position are included in the Corporation Comments and OIG Evaluation section of this report and in the Corporation's written comments included as Appendix VI. Taken as a whole, DSC's position and related comments had merit. We have, therefore, modified the recommendations to be the following legislative and regulatory options for consideration:

(1) Regulatory changes such as making the higher capital expectations specified in the Expanded Guidance on Subprime Loans part of the Call Report instructions, or some other method, to ensure that the reported capital ratios of institutions reflect the risk related to those loans.

(2) Legislative and regulatory changes to add the CAMELS rating or some other objective criteria as the trigger for implementing section 38(g).

(3) Legislative or regulatory changes to remove or lessen the due process provisions imposed by section 38(g).

(4) Legislative and regulatory changes needed to allow implementation of section 38(f)(2) when institutions become "undercapitalized."

(5) Regulatory changes to add objective or quantifiable criteria, such as CAMELS ratings, to section 39 provisions to trigger actions.

(6) Regulatory changes to make it mandatory to take corrective actions when institutions do not meet section 39 safety and soundness standards.

To facilitate consideration of these options to improve the effectiveness of PCA, we will include them in our Semiannual Report to the Congress. We also intend to provide copies of this report to the Senate Committee on Banking, Housing and Urban Affairs, House Committee on Financial Services, and the Chairman of the Federal Financial Institutions Examination Council (FFIEC) after the next FDIC Audit Committee meeting.

CORPORATION COMMENTS AND OIG EVALUATION

On September 4, 2003, the Corporation provided its comments on our legislative and regulatory options for consideration. The Corporation's comments generally agreed with our observations regarding the use and effectiveness of PCA provisions. However, the comments pointed out that the report did not consider the following important issues and factors that would complicate the implementation of proposed options: due process, unintended consequences, and congressional and public sentiment. While we agree that these issues and factors are important, we did not intend our report to discuss every issue and nuance of PCA provisions. Instead, we provided our observations and options for the Congress and the regulators to consider in any reassessment of the PCA provisions.

The Corporation's comments also offered other factors that should be considered and included specific comments for each option that we proposed for consideration. However, we would like to provide additional information in response to several statements included in the Corporation's comments.

Specifically, the Corporation stated:

> The GAO [General Accounting Office} studied the PCA rules in 1996, using a sample of 61 banks that had been subject to PCA actions, and issued a report. Although the GAO report noted the inherent limitations of the capital-based safeguards set forth in section 38 and the lack of objective criteria in section 39, it did not make any recommendations to change or amend the law or the implementing regulations.

We agree that the 1996 GAO report did not make any recommendations. However, the GAO report points out that few institutions were subject to section 38 enforcement actions from December 1992 through September 1996. In fact, for GAO's sample of 61 institutions, section 38 directives were used against only 8 institutions. Further, section 39 was not fully implemented until October 1, 1996, only 1 month before GAO issued its report in November 1996. Further, the same report points out that in 1991, the 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 and practices and the regulatory actions that would result if institutions violated the specified criteria. This recommendation was adopted and, until it was amended, the original legislation required quantitative standards for two of three areas under section 39. Therefore, we believe our options 2, 3, 5, and 6 only reiterate GAO's recommendations in 1991 to Congress and the regulators, and we would continue to offer them as options for consideration.

We acknowledge in our report that the regulators elected not to include higher capital requirements in the risk-based capital framework because of the difficulty in defining the term "subprime." However, we believe that subprime loans continue to pose a significant risk to the deposit insurance funds. Not establishing a formal method for reporting risk-weighted capital and depending on the periodic examinations to evaluate capital adequacy, in our opinion, do not mitigate the risks posed by subprime loans. Therefore, we would continue to offer option 1 for consideration.

Finally, in its response to option # 4, the Corporation stated that under section 38(e)(5), an undercapitalized institution may be subject to section 38(f)(2) if the agency determines it is necessary to carry out the purpose of section 38. Thus, section 38(f)(2) is already available to regulators when an institution becomes "undercapitalized." Our report observes that the authority available to the regulators under section 38(f)(2)(F) to require the institution to dismiss or replace bank officers or directors is not being used frequently. Specifically, our report pointed out that of the six of institutions in our sample that reached the "significantly undercapitalized" level and could have been subject to section 38(f)(2)(F) actions, the FDIC used the section authority for only two institutions. This contrasts with the multitude of examples of management deficiencies (included in Appendix IV) that the examiners identified during examinations. Further, our report also pointed out that the two banks for which the FDIC used this provision were closed within a month after the dismissal action was taken. Therefore, we continue to believe that changes to section 38(f)(2) should be made to promote the appropriate use of this important authority for both "undercapitalized" and "significantly undercapitalized" institutions, and we would continue to offer option 4 for consideration.

LIST OF INSTITUTIONS REVIEWED

Name	Closed/Acquired/Open	Date	Asset Size (in millions)[a]	Estimated Loss (in millions)[b]	Dollar Loss as a Percentage of Total Assets
Victory State Bank	Closed	03/26/99	$11.8	0	0
Bank of Honolulu	Closed	10/13/00	$61.2	$1.44	2.4%
Bank of Alamo	Closed	11/08/02	$59.8	$7.80	13.0%
Bank of Falkner	Closed	09/29/00	$75.7	$15.46	20.4%
Salt Lick Deposit Bank	Acquired	05/09/01	$46.6	0	0
Bank of Sierra Blanca	Closed	01/18/02	$10.5	$4.34	41.3%
Home State Bank	Acquired	12/29/00	$26.5	0	0
First Alliance Bank & Trust	Closed	02/02/01	$16.8	$0.82	4.9%
Open Bank # 1	Open	N/A	$876.5	N/A	N/A
Open Bank # 2	Open	N/A	$1,920.0	N/A	N/A
Open Bank # 3	Open	N/A	$1,850.0	N/A	N/A

a/ At institution closure per Division of Finance or most recent examination.
b/ Per Division of Finance's "Estimated Loss Report" as of 5/31/03.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of this review were to determine whether PCA provisions were used as part of the FDIC's enforcement process and served to reduce the losses to the deposit insurance funds. To achieve the objectives, we conducted in-depth analyses (case studies) of a sample of a total of 11 failed and open banks in order to gain insight into the use of PCA provisions. Institutions selected for review included only FDIC-supervised banks.

To select a sample of banks for our review, we contacted DRR and obtained a list of resolution cases for the period 2000, 2001, and 2002. The list contained the names of 22 banks that have failed or nearly failed, banks in which DRR was conducting work, and banks that DRR was monitoring. We did not test the list for its accuracy or completeness. Using a judgmental sampling approach, and in consultation with DSC and DRR, we selected 11 banks for review: 1 in DSC's Atlanta region, 5 in the Dallas region (Dallas-2, Memphis-3), 1 in the San Francisco region, and 4 in the New York region (New York-2, Boston-2). Based on DSC's suggestion, we included Victory State Bank in our sample even though it was closed in 1999. A listing of the banks we reviewed, eight failed or acquired and three open, is in as Appendix I. The open banks we studied are identified as Open Bank # 1, # 2, and # 3.

For each bank selected, we reviewed all available DSC files, including: FDIC and state reports of examination; supervisory actions initiated by the regulators, including C&Ds, PCA directives, and MOUs; results of supervisory visits; interoffice memorandums; correspondence between the regulators and bank officials; problem bank memorandums; and memorandums presenting detailed analyses of failures. We may not have reviewed all pertinent documents in cases for which corporate investigators and/or attorneys were using file documents at the time we performed our field visits. Additionally, we held discussions with corporate officials in headquarters offices of DSC, Legal, DRR, and DIR. At the FDIC Regional and Area Offices, we met with DSC regional and area office directors, assistant regional directors, and case managers. In analyzing the banks in our sample, we also reviewed their capital condition for the period covered by our audit. We did not, however, test the accuracy of the capital ratios that DSC had developed and provided to us for this part of our analysis. Following the completion of our analyses, we provided our case histories to DSC, Legal, DRR, and DIR for their review and comment. Their comments were incorporated into our report where appropriate.

To ensure our understanding of prompt corrective action provisions, we reviewed sections 38 and 39 and other related sections of the FDI Act. In addition, we reviewed the following previous audit reports:

- The FDIC Office of Inspector General (OIG) Audit Report No. 03-019, entitled *The Division of Supervision and Consumer Protection's Examination Assessment of Subprime Lending*, dated March 18, 2003;

- The FDIC OIGAudit Report No. 03-017, entitled *Material Loss Review of the Failure of the Connecticut Bank of Commerce, Stamford, Connecticut*, dated March 10, 2003.

- The FDIC OIG Audit Report No. 02-013, entitled *The Effectiveness of Prompt Corrective Action Provisions in Preventing or Reducing Losses to the Deposit Insurance Funds*, dated March 26, 2002;

- The GAO report, GAO/GGD 97-18, entitled *Implementation of FDICIA's Prompt Regulatory Action Provisions*, dated November 21, 1996.

We also reviewed the report entitled "Differentiating Among Critically Undercapitalized Banks and Thrifts" dated June 14, 2002. This report was from the FDIC's former Division of Research and Statistics, which conducted a review of bank failures that occurred from 1994 through 2000 and of banks that fell below the 2 percent capital requirement for the critically undercapitalized institutions. The report concluded that, from 1994 through 2000, most failures imposed significant costs (as a percentage of assets) on the insurance funds. However, 55 percent of the FDIC-insured institutions that fell below the PCA threshold for critically undercapitalized institutions avoided failure, and about 30 percent of the failed institutions never breached the PCA threshold.

We limited our assessment of DSC's system of internal controls to gaining an understanding of the division's procedures for reporting on undercapitalized institutions and section 38 and 39 provisions. We did not (1) test internal controls, (2) review Government Performance and Results Act reporting, (3) test for fraud or illegal acts, or (4) determine the reliability of computer-processed data obtained from the FDIC's computerized systems. However, the fact that we did not perform those tests, reviews, or assessment of the reliability of data did not affect our ability to achieve the stated audit objectives or the audit results. The audit was conducted from January 6, 2003 through June 16, 2003 in accordance with generally accepted government auditing standards.

ADDITIONAL BACKGROUND INFORMATION ON PROMPT CORRECTIVE ACTION PROVISIONS

The FDIC insures the deposits of banking and thrift institutions. However, the FDIC, the Board of Governors of the Federal Reserve System (FRB), 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. The FDIC is the primary federal regulator of state-chartered banks that are not members of the Federal Reserve System; the FRB regulates state-chartered, member banks; the OCC regulates nationally chartered banks; and the OTS regulates all federally insured thrifts, regardless of charter. The regulators carry out their oversight responsibilities primarily by monitoring financial data that institutions file with them, conducting periodic on-site examinations, and taking actions to enforce federal safety and soundness laws and regulations.

From 1980 through 1990, the failure of hundreds of banks and thrifts threatened the solvency of the federal deposit insurance funds. The insurance fund for banks (the Bank Insurance Fund) had a negative balance for the first time in its history. In addition, the insurance fund for thrifts (the Savings Association Insurance Fund) required a taxpayer bailout. This crisis resulted in deposit insurance fund losses estimated at over $125 billion. One of the many factors contributing to the size of the 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.

In response, the United States Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) to improve the supervision and examination of depository institutions and protect the insurance funds from further losses. Two new sections, sections 38 and 39, were enacted into the Federal Deposit Insurance Act. The 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.

Section 38, *Prompt Corrective Action*, was codified to 12 U.S.C. 1831o and section 39, *Standards for Safety and Soundness*, was codified to 12 U.S.C. 1831p-1. Section 38 provisions require federal regulators to initiate actions when an institution fails to meet minimum capital levels. Section 39 provisions address safety and soundness standards relating to factors other than capital.

Section 38(c) made capital the centerpiece of the PCA provisions because funds invested by owners can absorb losses before the institutions become insolvent. In addition, section 38(c) created a capital-based framework for bank and thrift oversight that is based on the placement of financial institutions into one of five capital categories. Section 38

required regulators to define criteria for four of the five categories, which are identified as well-capitalized, adequately capitalized, undercapitalized, and significantly undercapitalized. It also required 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 established a system of mandatory supervisory actions that are to be triggered by an institution's capital levels. Section 38 restricts depository institutions in the three lowest capital categories from engaging in certain activities that could increase the risk of loss to the federal deposit insurance funds. Table 8 shows the minimum capital levels established by the regulators for each of the five categories defined by section 38(c).

Table 8: Capital Categories and Ratios Defined by Section 38 Provisions

Capital Category	Total Risk-Based Capital	Tier 1 Risk-Based Capital	Leverage Capital
Well-capitalized	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
Significantly Undercapitalized	Less than 6 percent or	Less than 3 percent or	Less than 3 percent
Critically Undercapitalized	An institution is critically undercapitalized if its tangible equity is 2 percent or less regardless of its other capital ratios.		

Source: Section 38 of the *FDI Act* and 57 Federal Register 44866-01.

The regulators jointly developed the implementing regulations for section 38 based on the criteria for the top four capital categories on international capital standards and adopted section 38's tangible equity ratio of 2 percent as the threshold for the critically undercapitalized category. 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 three ratios listed for its capital category.

Section 7 of the FDI Act requires all insured financial institutions to submit Call Reports or Thrift Financial Reports (TFR) to their primary federal regulators each quarter. Primary regulators determine the capital categories for section 38 purposes using the information that institutions provide in their Call Reports or TFRs. Under the banking agencies' risk-based guidelines, assets and credit equivalent amounts of derivatives and off-balance sheet items are assigned to one of several broad risk categories according to obligor, or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each risk category is then multiplied by the risk weight associated with that category. The resulting weighted values from each of the risk categories are added together, and generally, this sum is the bank's total risk-weighted assets, which comprises the denominator of the risk-based capital ratio. Appendix A to part 325 of the FDIC

Regulations establishes FDIC's Statement of Policy on Risk-Based Capital. The risk-weights associated with various asset types that institutions should apply to their assets are included under "Schedule RC-R – Regulatory Capital," of Call Report Instructions. 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. Tier 2 capital includes subordinated debt, loan loss reserves, and certain other instruments. Leverage capital is computed without risk weights.

To simplify and illustrate the computation of leverage and Tier 1 risk-based capital, the example below considers an institution with assets of $200 and $8 in Tier 1 capital.[16]

- If that institution's assets had a risk-weight of 100 percent, both its leverage and Tier 1 risk-based capital ratios would be 4 percent. The leverage capital ratio is computed by dividing $8 in capital by $200 in assets. The Tier 1 risk-based capital ratio is computed as follows: $8/$200 ($200 multiplied by 1 for 100 percent risk weight). So, for PCA purposes, this bank would be considered "Adequately capitalized."

- If that same institution's assets had a risk-weight of 150 percent, its leverage capital would still be 4 percent ($8 divided by $200 in assets). However, the risk-based capital for this institution would be 2.67 percent computed as follows: $8 in capital divided by $300 ($200 in assets multiplied by 1.5 for a risk weight of 150 percent). With its Tier 1 risk-based capital of 2.67 percent, this institution would be considered "significantly undercapitalized" for PCA purposes.

Depository institutions that do not meet minimum capital levels face several mandatory restrictions or actions. Section 38(e) provisions applicable to restrictions on undercapitalized institutions mandate that federal regulators require institutions to (1) submit capital restoration plans; (2) restrict the growth of assets; and (3) obtain prior approval for additional acquisitions, branches, and new lines of business. Section 38 allows regulators to take additional actions against an undercapitalized institution, if considered necessary.

Under section 38, institutions that are classified as significantly undercapitalized face more stringent restrictions. Regulators must take one or more of the following actions:

- Require the sale of equity or debt or, under certain circumstances, requiring institutions to be acquired by or merged with another institution.
- Restrict otherwise allowable transactions with affiliates.
- Restrict the interest rate paid on deposits by institutions.
- Impose more stringent asset growth limitations than required for undercapitalized institutions or require the institution to reduce its total assets.
- Require the institution, or its subsidiaries, to alter, reduce, or terminate an activity that the regulator deems excessively risky to the institution.

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[16] Section 38 requires three measures of capital—Total Risk-based, Tier 1 Risk-based, and Leverage capital. For the sake of simplicity and to explain the concept of risk-based capital, we used only two measures in this example.

- Improve 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.
- Prohibit acceptance, renewal, or rollover of deposits from correspondent banks.
- Require prior approval for capital distributions from holding companies having control of the institution.
- Require divestiture by (1) the institution of any subsidiary that poses significant risk to the institution, (2) the parent company of any nondepository affiliate that poses a significant risk to the institution, and/or (3) any controlling company of the institution if that divestiture would improve the institution's financial condition.
- Prohibit payment of bonuses to or increasing compensation of senior executive officers without prior approval.

Each regulator is responsible for taking the actions included in section 38 for the institutions it supervises. When an institution becomes critically undercapitalized, federal regulators must either appoint the FDIC as conservator or receiver or take other action to minimize losses to the insurance funds within 90 days of becoming aware of the institution's condition. Section 38 also prohibits critically undercapitalized institutions from doing any of the following without the FDIC's prior written approval:

- Entering into any material transaction (such as investments, expansion, and asset sales), other than in the normal course of business.
- Extending credit for any highly leveraged transaction.
- Amending the charter or bylaws, except to carry out any other requirement of any law, regulation, or order.
- Making any material changes in accounting methods.
- Engaging in any covered transactions.
- Paying excessive compensation or bonuses.
- 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.
- Paying principal or interest on the institution's subordinated debt beginning 60 days after becoming critically undercapitalized.

Section 38(d) provisions applicable to all institutions prohibit them from making capital distributions or paying management fees that would drop them into the undercapitalized category. In addition, according to section 29 of the FDI Act, codified to 12 U.S.C. §1831f, an adequately capitalized institution cannot accept brokered deposits without a waiver from the FDIC.

Finally, section 38 permits regulators to, in effect, downgrade an institution by one capital category if the institution is in unsafe or unsound condition or if it is engaging in an unsafe and unsound practice. For example, regulators can downgrade an adequately capitalized institution to the undercapitalized category if the institution received a less than satisfactory rating in its most recent examination report for asset quality, management, earnings, or liquidity. By downgrading an institution, the regulators can require the institution's compliance with those restrictions applicable to undercapitalized

institutions. This provision allows regulators to take action against an institution that poses a danger to the deposit insurance funds from factors other than its capital level.

Further, to limit deposit insurance losses caused by factors other than inadequate capital, Section 39 of the FDI Act requires each regulator to establish certain safety and soundness standards related to (1) operations and management; (2) asset quality, earnings and stock valuation; and (3) compensation. To allow for flexibility among the regulators based on the scope and nature of the agencies' activities, the regulators elected to adopt broad guidelines instead of strict numerical standards. The guidelines were designed to prompt depository institutions to implement measures that would assist in identifying emerging problems in areas other than capital and to correct those problems before capital became impaired.

EXAMPLES OF DEFICIENCIES IDENTIFIED BY EXAMINERS

In reviewing the eight banks in which PCA directives were used, we observed that in all cases, the examiners identified deteriorating asset quality, which culminated from deficiencies related to bank management and/or board oversight. Examples of deficiencies identified included the following:

- Problems related to one person dominating the institution.

  - In the case of the Bank of Honolulu, the Chairman of the Board, who owned over 99 percent of the bank, engaged in a number of insider transactions with foreign individuals to whom the bank had extended $6 million in unsecured international loans. These loans played a significant role in the eventual failure of the bank.

  - The extremely weak asset quality of the Bank of Sierra Blanca was attributable to the reckless and self-serving lending practices of its President, who resigned prior to the bank's failure. This individual apparently originated and approved loans in violation of state lending limits, released collateral without corresponding reductions in the related loan, and promoted the interests of another entity that employed him.

  - The closure of Victory State Bank was primarily the result of problems stemming from the Chairman's disregard for the bank's financial well being. The Chairman's excessive compensation over the years was the major contributor to the bank's operating losses and depletion of capital. He dominated all aspects of Victory's operations and failed to implement corrective measures to address the continuing deterioration of the bank's condition, primarily resulting from weak underwriting and credit administration practices.

- Weak or inadequate Board oversight.

  - In the case of Victory State Bank, in spite of the fact that the FDIC questioned the reasonableness of the Chairman's compensation, the Board took no action regarding the Chairman's excessive compensation or the detrimental influence he exerted on the bank.
  - In the case of Salt Lick Bank, the examiners noted that the Board of Directors permitted the President of the bank to operate the institution in a hazardous and objectionable manner.
  - In November 2001, the FDIC examiners dropped the composite CAMELS rating from a 2 to a 4 for Open Bank # 2. The examiners noted that the increase in its risk profile was due to a marked decline in the credit quality of subprime assets, a significantly under-funded ALLL, an inadequate capital level, imprudent credit management practices, and other managerial

deficiencies. Examiners attributed many of the problems to weak Board oversight, particularly in the areas of credit standards and underwriting.

- Insider lending or related abuses.

  - In the case of Home State Bank, state examiners determined that a sizable portion of the bank's asset quality problems were directly related to the former Board Chairman and related family and business interests. Specifically, loans directly tied to or influenced by the former Chairman comprised 35 percent of classified loans as of December 1999, at which time the bank's capital category was lowered from "adequately capitalized" to "significantly undercapitalized."[17] This individual resigned before the bank was closed.

  - Without informing the regulators, the Bank of Alamo's Chairman of the Board had pledged his bank ownership as collateral on a loan of approximately $4.2 million because he was experiencing great financial difficulty. Examiners also noted that the Chairman and the Bank of Alamo were named as defendants in a complex lawsuit involving several interests of the Chairman. The plaintiff in this lawsuit alleged specific acts of fraud, racketeering, and other violations. In addition, the examiners noted that the Chairman was continuing to make decisions that adversely impacted the bank, including drawing various personal financial benefits without seeking Board approval.

- Lack of expertise and/or qualified personnel.

  - Shortly after the First Alliance Bank and Trust Company opened, a joint visitation by the state and the FDIC disclosed deficiencies related to many of the bank's policies and procedures and a need for management to develop a strategic plan. Problems at the institution were magnified by changes in leadership. During the bank's first 2 years, the bank had three different presidents with different goals and objectives. In addition, during the bank's 4-year existence, six of the initial directors resigned, four of whom were the only board members with prior banking experience. Other directors who had joined the Board after the bank was established also departed. Also, management continuously deviated from the business plan.

  - An individual who had been a Board member for 23 years took control of policy-making and day-to-day operations of the Bank of Alamo without formal bank

[17] Classified loans are loans that are not protected adequately by the current sound worth and paying capacity of the borrower or the collateral pledged. Therefore, full liquidation of the debt may be in jeopardy.

training. Further, he appointed another individual, a veterinarian, as President.

- Holding company control.

  - For Open Bank # 1, examiners reported that Board oversight was lacking and that all critical management decisions and functions were performed by officers of affiliated entities of the parent company. The parent of Open Bank # 1 also owned a national bank.[18] In addition, examiners noted that Open Bank # 1 (in reality, the parent) had commenced an aggressive strategy for loan growth that contributed to significant deterioration in the bank's asset quality.

- For Open Bank # 3, examiners noted that the bank's Board had allowed officers of the parent company to make significant decisions. In addition, the examiners noted that the organizational structure of the bank and its position within the parent company did not provide the bank's Board with the necessary independence to accomplish its fiduciary responsibilities. The parent company of Open Bank # 3 also owned a national bank, and examiners noted that the state non-member bank was being operated as a branch of the national bank.

[18] According to DSC, the parent is not required to register as a bank holding company under the Bank Holding Companies Act. The parent owns the national bank, which is a "bank" as defined under the BHCA, as amended by the Competitive Equality Banking Act of 1987 (CEBA). However, under grandfathering provisions of CEBA, the parent is not required to register as a bank holding company because the national bank, which takes demand deposits but does not make commercial loans, did not fall within the BHCA definition of the term "bank" prior to the enactment of CEBA. Under CEBA, the state non-member bank is not considered a "bank" for purposes of the BHCA. Accordingly, the parent is not subject to examination by the Federal Reserve.

GLOSSARY

Allowance For Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL at a level that is adequate to absorb the estimated credit losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as standby letters of credit.
Call Report	An institution's quarterly *Consolidated Report of Condition and Income* that contains a balance sheet, income statement, and other detailed financial schedules containing information about the institution.
CAMEL(S) Rating	The FDIC and other regulators use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a financial institution's performance. Areas of financial and operational concern are evaluated and given a numerical rating of "1" through "5" with "1" having the least concern and "5" having the greatest concern. The performance areas identified by the CAMEL acronym are capital adequacy, asset quality, management, earnings, and liquidity. A sixth component, sensitivity to market risk, was added in December 1996 changing the acronym to CAMELS.
Capital	Funds invested in a bank, including Common Stock and qualifying Preferred Stock, Mandatory Convertible securities, such as Capital Notes, plus retained earnings.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. A concentrations schedule is one of the pages that may be included in the *FDIC's Report of Examination*. As a general rule, concentrations are listed by category according to their aggregate total and are reflected as a percentage of Tier 1 Capital.
Credit Enhancements	Credit enhancements may be either internal or external. Internal enhancements are created by redirecting internal cash flows and include senior-subordinate structures and cash reserve accounts funded by the originator. External enhancements are not dependent on redirecting internal cash flows and include letters of credit from banks, surety bonds from insurance companies, guarantees from financial assurance companies, and subordinated loans from third parties.
Leverage Capital	Banks must maintain at least the minimum leverage requirement set forth in part 325 of the *FDIC Rules and Regulations*. The minimum leverage requirement consists of only Tier 1 (Core) capital.

Residual Assets	Residual Assets represent claims on the cash flows that remain after all obligations to investors and any related expenses have been satisfied.
Risk-Based Capital	A "supplemental" capital standard under part 325 of the *FDIC Rules and Regulations*. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).
Risk-Weighted Assets	A system of calculating the risk-weighting of assets by assigning assets and off-balance sheet items to broad risk categories.
Securitization	The process of pooling similar, illiquid loans and issuing marketable securities backed by those loans. The securities are sold, and investors in transactions receive a share of the generated cash flow.
Subprime loan	A loan made to a borrower whose credit is below good credit standards and whose loans are usually referred to as marginal, nonprime, or below "A" quality loans. Those borrowers pose a greater risk and are characterized by paying debts late, filing for personal bankruptcy and/or having an insufficient credit history.
Tangible Equity Capital	Core capital plus outstanding cumulative perpetual preferred stock.
Thrift Financial Report	A thrift's quarterly financial report that contains a balance sheet, income statement, and other detailed financial schedules. Thrifts submit these reports to the Office of Thrift Supervision.
Tier 1 (Core) Capital	Defined in part 325 of the *FDIC Rules and Regulations* and is the sum of: • common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, and foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • non-cumulative perpetual preferred stock; and • minority interest in consolidated subsidiaries **minus** • intangible assets; • identified losses; • investments in securities subsidiaries subject to section 337.4; and • deferred tax assets in excess of the limit set forth in section 325.5(g) of the *FDIC Rules and Regulations*.
Tier 2 (Supplemental Capital)	Tier 2 capital is defined in part 325 of the *FDIC Rules and Regulations*, and is generally the sum of: • allowances for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets; • cumulative perpetual preferred stock, long-term preferred

	stock and related surplus; • perpetual preferred stock (dividend is reset periodically); • hybrid capital instruments; and • term subordinated debt and intermediate-term preferred stock.
Total Risk-Based Capital	Total Risk-Based capital consists of the sum of Tier 1 and Tier 2 capital.
Total Risk-Based Capital Ratio	Total qualifying capital divided by risk-weighted assets.

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Division of Supervision and Consumer Protection

September 4, 2003

TO: Stephen M. Beard
Deputy Assistant Inspector General for Audits

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

CONCUR: John F. Bovenzi
Deputy to the Chairman and Chief Operating Officer

SUBJECT: Draft Report Entitled, *The Role of Prompt Corrective Action (PCA) as Part Of the Enforcement Process* (Assignment No. 2003-016)

Thank you for the opportunity to review and comment upon your report. The stated objective of the audit associated with this report is to determine whether Prompt Corrective Action (PCA) provisions were used as part of the FDIC's enforcement process and served to reduce the losses to the deposit insurance funds.[1] This audit covers a sample of 11 FDIC-supervised institutions and is an expansion of an earlier audit that focused on whether prompt corrective action provisions were implemented in a timely manner.

We have closely reviewed the results of this audit. This report has been distributed to our Regional Directors and all other managers involved in the enforcement action process for their review.

With respect to the audit's stated objective, the report's findings are summarized on page 5 as follows:

> *The FDIC generally used PCA directives as part of the supervisory process, in conjunction with other supervisory actions, once institutions' capital levels reached designated thresholds. Specifically, the FDIC used PCA directives in 8 of 11 institutions that we reviewed, and its use of PCA served to prevent or reduce losses to the deposit insurance funds.*

We appreciate and concur with the report's favorable finding with respect to the FDIC's appropriate use of PCA. We believe that PCA, as currently structured, has been a valuable addition to the enforcement tools available to the federal banking agencies.

The report also focuses considerable attention on the general effectiveness of PCA as an enforcement tool. In summary, the report states the following:

[1] FDIC Office of Inspector General Report: *The Role of Prompt Corrective Action as Part of the Enforcement Process* (Assignment Number 2003-016), p. 1.

> *While PCA directives were used in 8 of 11 institutions in our sample, we identified a number of factors that delay the use of section 38 and impact the effectiveness of its capital related provisions.*[2]
>
> *[With regards to the use of non-capital factors on which PCA directives can be taken,] our analyses of these sections indicated that these provisions do not provide objective or measurable criteria for implementation and, in some instances, placed restrictions on their use. Consequently, these provisions were seldom used, and the FDIC* ***may*** **[emphasis added]** *have lost opportunities to initiate additional supervisory actions to address problems.*[3]

To address these issues, the draft report made 6 recommendations "...to fulfill the Congressional intent and to provide the primary banking regulators with a more effective set of supervisory tools."[4] Following discussions with DSC staff, the OIG revised its formal recommendations to options for consideration by the federal banking agencies and Congress.

We have carefully considered the options proposed in this report, as well as other important issues and factors in regard to the role of PCA as part of the enforcement process. While we appreciate that the focus and intent of the options are to improve the effectiveness of the PCA process, we do not believe that the proposed changes are necessary.

Prompt Corrective Action is but one of many enforcement tools available to effect corrective measures in problem institutions. Since the implementation of the PCA requirements in 1992, the FDIC has taken enforcement actions on over 300 banks. Based on this experience, we believe we currently have an adequate and effective set of enforcement tools to deal with problem institutions. In fact, the report acknowledges that the enforcement actions already in place through section 8 actions in this sample of banks mandated many of the same actions as if a PCA action had been taken.

Furthermore, there are several important issues and factors that are either not discussed in the report or are not fully explained. These include:

(1) the need to provide adequate procedural protections to insured institutions and individuals prior to the agencies taking any discretionary action;
(2) the recognition that there are many circumstances where PCA actions could result in unnecessary and counterproductive actions being taken against financially sound institutions; and
(3) the fact that the agencies have jointly solicited public comments on these issues on several occasions before the rules were implemented, and the overwhelming number of commenters were opposed to imposing a rigid set of specific standards.

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[2] OIG Report, p. 5.
[3] OIG Report, p. 7-8.
[4] OIG Report, p. 50.

We have provided a more detailed discussion of these issues, as well as comments on the specific options listed in the report, on the pages that follow.

The proposed changes to the existing enforcement framework are significant. We do not believe that Congress, the banking industry, or the other regulators would be receptive to proposals that increase the application of the prescriptions in sections 38 and 39 unless there are clear and convincing benefits to the insurance funds. Without such evidence, the pursuit of legislative and regulatory changes to PCA does not appear to be a productive use of resources.

However, we will continue to review and consider the impact on PCA of regulatory changes to the risk-based capital requirements. The risk-based capital requirements have been revised several times since the passage of PCA to cover interest rate risk, nontraditional financial products, and expanded credit risk standards. There are several interagency efforts ongoing regarding risk-based capital standards and the impact of these changes on the PCA regulations is an important factor that receives full and complete consideration.

General Comments on the Report's Options for Consideration

The report focuses on factors that delay the use of section 38 and impact the effectiveness of its capital related provisions. Specifically, these include:

- Capital can be a lagging indicator of an institution's financial health.
- Capital ratios reported by institutions in their Call Reports did not always reflect actual financial conditions.
- Institutions increased their capital before or after the issuance of PCA directives or closure.
- The current method of computing capital does not take into account risks related to subprime loans.

We agree that these are important factors. It is important to note, however, that all these issues, with the exception of the subprime issue, were fully considered during the rulemaking process when the PCA regulations were implemented. The results in this report do not provide any new or unknown factors since that time.

As noted above, the report does not adequately consider several important issues and factors that would complicate the implementation of the options proposed or would discourage their adoption altogether. These include:

Due process. After considerable Congressional debate, the PCA rules included a separate procedure that allows regulators to subject an institution to more stringent treatment based on supervisory factors other than capital (the "Reclassification Rule"). The process includes adequate procedural protections to insured institutions and individuals incident to the agencies taking any discretionary actions. The FDIC is required by statute to prove

particular statutory elements and that certain due process procedures are followed in the use of these enforcement powers.

While the report does note the existence of this treatment and these restrictions, it does not explain the rationale behind these protections. Furthermore, the report does not investigate whether these protections are too restrictive or cause significant harm to the insurance funds. If the regulations were changed to include a trigger for the PCA provisions other than capital, these protections would be greatly diminished.

Unintended consequences. The use of triggers such as CAMELS ratings or other criteria would be a fundamental change to the PCA framework that would unduly restrict regulatory flexibility and discretion. These triggers would create many circumstances where PCA actions could result in unnecessary and counterproductive actions being taken against financially sound institutions. We do not believe there is a set of measures or criteria that would be appropriate for all institutions given their differing sizes, types of activities, risk profiles and levels of management expertise.

As for CAMELS, while there are numerical ratings resulting from the evaluation of an institution's condition and risk management practices, the analysis is subjective and the evaluation factors aren't tied to objective measures and criteria. In our experience, there are many cases, particularly for smaller institutions whose loans are all tied to the local economy, where, despite good management and compliance with sound policies and procedures, economic factors outside management's control has adversely affected asset quality and resulted in a less than satisfactory CAMELS rating. The capital ratios of these institutions often have been well above the well capitalized threshold, in part because management maintained higher capital levels so the institution could weather this sort of situation and work its way out of it. We do not think we should unduly restrict our regulatory discretion and flexibility in situations such as this.

Congressional and public sentiment. The current enforcement framework has been established through extensive Congressional debate and an exhaustive public review and comment process. Section 38 was written to require that the PCA rules tie into the agencies' existing capital rules only after extensive Congressional debate and public comment. With regard to section 39, the Standards for Safety and Soundness, the agencies solicited public comments on 3 separate occasions before the rule was implemented. 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 proposed changes in the report regarding section 39 are in direct conflict with these comments and the structure of the regulation that was established in response to these comments and concerns.

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Other important factors that should be considered include:

- Many of the PCA provisions are directed at actions that either require the institution to retain capital, restore capital, or sell additional capital, thus attempting to limit loss to the deposit insurance funds. PCA actions really do not directly address the practices or conditions that caused the problems or prescribe actions to correct these problems. The regulators use their other enforcement powers to directly address these practices and conditions.

- While the report acknowledges that infusions of capital strengthen the condition of an institution, it states that institutions do this to avoid implementation of or to terminate PCA directives. However, the report does not acknowledge that once the FDIC has issued a PCA directive, it contains language that the directive shall not be set aside, modified, or otherwise terminated without the prior written approval of the FDIC. Thus, an infusion of capital does not automatically terminate a PCA directive.
  We also do not believe that the report has adequately considered and explained the interagency aspects (and thus the need solicit the views and support of the other agencies before we propose regulatory changes) of these rules.

- The GAO studied the PCA rules in 1996, using a sample of 61 banks that had been subject to PCA actions, and issued a report. Although the GAO report noted the inherent limitations of the capital-based safeguards set forth in section 38 and the lack of objective criteria in section 39, it did not make any recommendations to change or amend the law or the implementing regulations.

Response to Specific Options Listed in the Report

The first option deals with the factor of accounting for risk associated with subprime loans.

1) *Regulatory changes such as making the higher capital expectations specified in the FFIEC Expanded Guidance on Subprime Loans part of the Call Report instructions, or some other method, to ensure that the reported capital ratios of institutions with subprime loans reflect the risk related to those loans.*

   Response: The FFIEC cannot impose capital reporting requirements based on the higher capital expectations discussed in the January 31, 2001, Expanded Guidance for Subprime Lending Programs (Subprime Guidance). The Call Report instructions for the regulatory capital schedule (Schedule RC-R) require banks to report based on the agencies' regulatory capital standards, which have been established through rulemaking.

   The Subprime Guidance, including the higher capital expectations discussed therein, is not a formal rule. Thus, in order to convert the factors outlined in the Subprime Guidance into an explicit capital requirement for all subprime lenders, we would have to go through the rulemaking process to incorporate higher capital requirements for subprime loans into the

risk-based capital framework. The agencies carefully considered this option when developing the January 2001 guidance, but elected not to do so for several reasons. Among these reasons is the difficulty in defining the term "subprime" and the broad spectrum of credit and other risks posed by subprime lending. The agencies determined, after considerable debate that lasted well over a year, that the capital framework for subprime lending should be sufficiently flexible to reflect the significant variance in the relative quality of subprime loan portfolios and in the corresponding risk management programs of individual subprime lenders. Such flexibility is best achieved outside the scope of a formal rule. Instead, an institution has to self-identify its appropriate level of capital and document its methodology, and the examiner must evaluate the institution's self assessments as well as its overall capital adequacy. Therefore, the verification of higher risk weightings is dependent on the examination process itself, and it would be virtually impossible to enforce higher risk weightings using the current reporting structure.

This proposal likely arises out of the observation noted on page 31 of the report, which states, "...under the current method of reporting, institutions do not risk-weight subprime loans in their Call Reports as suggested by the Expanded Guidance, resulting in inflated capital ratios, which may delay initiation of a PCA directive." This is not necessarily true in all cases. An institution can be required to risk-weight its subprime loans at greater than 100% and to reflect this treatment in its Call Report by incorporating a specific requirement to do so in a formal enforcement action such as a C&D. The FDIC has incorporated such provisions in the Orders of a few subprime lenders for which it is the primary supervisor. For these institutions, the higher capital levels that would otherwise be held pursuant to informal guidance have become formal requirements, thus the higher risk-weighting on the Call Report schedule is appropriate. An example of this is included in the report with respect to Open Bank #2, in which the FDIC has effectively made a higher risk-weighting for subprime loans a formal requirement through a cease and desist order. However, in other cases where banks have voluntarily agreed to hold more capital against its subprime loans in accordance with the Subprime Guidance, they would continue to risk-weight their subprime loans at not more than 100% in the Call Report.

We recognize that the intent of this option is to provide the agencies with better, more frequent information about the risks inherent in subprime loan portfolios. This was also the intent of the two separate FFIEC proposals, published for comment in May 2000 and July 2002, to collect subprime loan data on the Call Reports. The FFIEC chose not to implement either of these proposals after careful and lengthy consideration of the comments received. The agencies concluded, most recently in December 2002, that the examination process should continue to be the focal point of the supervision of the subprime lending activities.

Since this report does not provide any new or additional information that was not considered at the time that the Subprime Guidance was developed or when the FFIEC elected not to include subprime loan data in the Call Report, we do not think it is worthwhile to revisit these issues at this time.

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The other 5 options are intended to improve the effectiveness of sections 38 and 39. While we do not dispute the assertion that the implementation of these proposed changes would make sections 38 and 39 have a greater impact on a larger number of institutions, we do not believe that this would be fulfilling the Congressional intent or prove beneficial in a number of circumstances. The issues previously discussed in this response apply to these 5 options as a group and individually. Specifically, the report proposes the following options for consideration:

2) *Legislative and regulatory changes to add the CAMELS rating or some other objective criteria as the trigger for implementing section 38(g).*

3) *Legislative or regulatory changes to remove or lessen the due process provisions imposed by section 38(g).*

Response: For a section 38(g) reclassification, the FDIC is required to make a determination, after notice and a hearing, that the institution is in an unsafe or unsound condition or is engaging in an unsafe or unsound practice under section 8(b)(8) of the Federal Deposit Insurance Act. The definition of an "unsafe or unsound condition" has long been left to agency discretion, and such has been upheld by the courts. There appears to be no reason to require the FDIC to define the term objectively simply for PCA reasons. Indeed, doing so may likely limit rather than expand the use of PCA. We also do not think that Congress or the industry would be receptive to a request to remove the procedural protections of insured institutions and individuals. It should be noted that the current scheme of PCA has been generally criticized as lacking in due process because, unlike other enforcement actions, there is no formal hearing process, only an informal agency hearing. This scheme of capital based triggers has been approved by the courts while not requiring more formal and lengthier procedures. It is very questionable whether the use of "objective measures" as a trigger would receive such approval.

Also, the report states that these proposed changes are based, in part, on the conclusion that institutions avoided implementation of PCA directives by increasing capital before the issuance of a PCA directive. While we agree that an infusion of capital before PCA is used would preclude the use of PCA, it certainly would not preclude other supervisory approaches that might be more appropriate in such circumstances.

4) *Legislative and regulatory changes needed to allow implementation of section 38(f)(2) when institutions become "undercapitalized."*

Response: According to the Legal Division, section 38(f)(2) is already available to institutions other than those that are significantly undercapitalized. PCA provides that an undercapitalized institution without an acceptable capital plan is subject to section 38(f)(2), and under 38(e)(5), an undercapitalized institution may be subject to section 38(f)(2) if the agency determines it is necessary to carry out the purposes of section 38. Thus, section 38(f)(2) is already available to regulators when an institution becomes 'undercapitalized.'"

5) *Regulatory changes to add objective measures or quantifiable criteria, such as CAMELS ratings, to Section 39 provisions to trigger actions.*

6) *Regulatory changes to make it mandatory to take corrective actions when institutions do not meet section 39 safety and soundness standards.*

Response: The guidelines for section 39 were enacted after a very lengthy process that involved 3 separate solicitations for public comments. Section 39, as originally passed in 1991, sought to have the agencies enact stringent regulations. However, after the overwhelming number of public comments were opposed to such stringent objective measures and quantifiable criteria, Congress amended section 39, retroactive to its enactment, to provide the agencies more discretion and to "remove regulatory micromanagement."[6] The current balance between sections 38 & 39, and the use of section 8 and other enforcement powers is adequate for the FDIC's needs. Generally, section 8 actions have a much broader scope and are specifically tailored to the institution. There is no clear or convincing evidence in this report that more stringent measures to section 39 are needed, and nor should these "guidelines" be changed to standards that require mandatory actions.

We again thank you for the opportunity to comment on the report and recommend that these comments be considered.

[6] See H.R. Rep. No. 652, 103d Cong., 2d Sess. 174-75(1994);139 Cong. Rec. H10,516 (daily ed. Nov.21, 1993)

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