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DEPOSIT INSURANCE

Assessment of Regulators' Use of Prompt Corrective Action Provisions and FDIC's New Deposit Insurance System

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GAO-07-242

Highlights

Highlights of GAO-07-242, a report to congressional committees

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Assessment of Regulators' Use of Prompt Corrective Action Provisions and FDIC's New Deposit Insurance System

Why GAO Did This Study

The Federal Deposit Insurance Reform Conforming Amendments Act of 2005 required GAO to report on the federal banking regulators' administration of the prompt corrective action (PCA) program under section 38 of the Federal Deposit Insurance Act (FDIA). Congress created section 38 as well as section 39, which required regulators to prescribe safety and soundness standards related to noncapital criteria, to address weaknesses in regulatory oversight during the bank and thrift crisis of the 1980s that contributed to deposit insurance losses. The 2005 act also required GAO to report on changes to the Federal Deposit Insurance Corporation's (FDIC) deposit insurance system. This report (1) examines how regulators have used PCA to resolve capital adequacy issues at depository institutions, (2) assesses the extent to which regulators have used noncapital supervisory actions under sections 38 and 39, and (3) describes how recent changes to FDIC's deposit insurance system affect the determination of institutions' insurance premiums. GAO reviewed regulators' PCA procedures and actions taken on a sample of undercapitalized institutions. GAO also reviewed the final rule on changes to the insurance system and comments from industry and academic experts.

www.gao.gov/cgi-bin/getrpt?GAO-07-242.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Yvonne D. Jones at (202) 512-8678 or jonesy@gao.gov.

What GAO Found

In recent years, the financial condition of depository institutions generally has been strong, which has resulted in the regulators' infrequent use of PCA provisions to resolve capital adequacy issues of troubled institutions. Partly because they benefited from a strong economy in the last decade, banks and thrifts in undercapitalized and lower capital categories decreased from 1,235 in 1992, the year regulators implemented PCA, to 14 in 2005, and none failed from June 2004 through January 2007. For the banks and thrifts GAO reviewed, regulators generally implemented PCA in accordance with section 38. For example, regulators identified when institutions failed to meet minimum capital requirements, required them to implement capital restoration plans or corrective actions outlined in enforcement orders, and took steps to close or require the sale or merger of those institutions that were unable to recapitalize. Although regulators generally used PCA appropriately, capital is a lagging indicator and thus not necessarily a timely predictor of problems at banks and thrifts. In most cases GAO reviewed, regulators had responded to safety and soundness problems in advance of a bank or thrift's decline in required PCA capital levels.

Under section 38 regulators can take noncapital supervisory actions to reclassify an institution's capital category or dismiss officers and directors from deteriorating institutions, and under section 39 regulators can require institutions to implement plans to address deficiencies in their compliance with regulatory safety and soundness standards. Regulators generally have made limited use of these authorities, in part because they have chosen other informal and formal actions to address problems at troubled institutions. According to the regulators, other tools, such as cease-and-desist orders, may provide more flexibility than those available under sections 38 and 39 because they are not tied to an institution's capital level and may allow them to address more complex or multiple deficiencies with one action. Regulators' discretion to choose how and when to address safety and soundness weaknesses is demonstrated by their limited use of section 38 and 39 provisions and more frequent use of other informal and formal actions.

Recent changes to FDIC's deposit insurance system tie the premiums a bank or thrift pays into the insurance fund more directly to the estimated risk the institution poses to the fund. In the revised system, FDIC generally (1) differentiates between larger institutions with current credit agency ratings and $10 billion or more in assets and all other, smaller institutions and (2) requires all institutions to pay premiums based on their individual risk. Most bankers, industry groups, and academics GAO interviewed and many of the organizations and individuals that submitted comment letters to FDIC on the new system generally supported making the system more risk based, but also had some concerns about unintended effects. FDIC and the other federal banking regulators intend to monitor the new system for any adverse impacts.

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Abbreviations

BSA	Bank Secrecy Act
CAMELS	capital, asset quality, management, earnings, liquidity, sensitivity to market risk
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
IG	inspector general
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
PCA	prompt corrective action
Y2K	Year 2000

GAO Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

February 15, 2007

The Honorable Christopher J. Dodd
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

With the failure of more than 2,900 federally insured banks and thrifts in the 1980s and early 1990s, federal regulators were criticized for failing to take timely and forceful action to address the causes of these failures and prevent losses to the deposit insurance fund and taxpayers.[1] In response to the federal banking regulators' failure to take appropriate action, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), implementing significant changes to the way banking regulators supervise the nation's depository institutions.[2] FDICIA created two new sections in the Federal Deposit Insurance Act (FDIA)—sections 38 and 39—that required the federal banking regulators to create a two-part framework to supplement their existing supervisory authority to address capital deficiencies and unsafe or unsound conduct, practices, or conditions.[3] The addition of sections 38 and 39 to FDIA were intended to improve the ability of regulators to identify and promptly address deficiencies at an institution to better safeguard the deposit insurance

[1]Under the Federal Deposit Insurance Reform Act of 2005, title II, subtitle B of Pub. L. No. 109-171, 120 Stat. 4, 9-21 (2006), the Bank Insurance Fund and the Savings Association Insurance Fund, which insured deposits in banks and thrifts, respectively, were merged into a combined Deposit Insurance Fund effective March 31, 2006. Throughout this report we use "deposit insurance fund" to refer to both funds individually and collectively.

[2]Pub. L. No. 102-242, 105 Stat. 2236 (1991).

[3]Act of September 21, 1950, ch. 967, 64 Stat. 873 (1950).

fund. Specifically, section 38 requires regulators to classify depository institutions into one of five capital categories based on their level of capital—well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized—and take increasingly severe actions, known as prompt corrective action (PCA), as an institution's capital deteriorates.[4] Section 38 primarily focuses on capital as an indicator of trouble, thus the supervisory actions authorized under it are almost exclusively designed to address an institution's deteriorating capital level (for example, requiring undercapitalized institutions to implement capital restoration plans). However, section 38 also authorizes noncapital supervisory actions (for example, removing officers and directors or downgrading an institution's capital level).[5] Section 39 required the banking regulators to prescribe safety and soundness standards related to noncapital criteria, including operations and management; compensation; and asset quality, earnings, and stock valuation, and allows the regulators to take action if an institution fails to meet one or more of these standards.[6] Since the passage of FDICIA, banks and thrifts have benefited from a strong economy, but this has not diminished the importance of the need for regulators to take early and forceful action to address capital and noncapital deficiencies.

FDICIA also granted the Federal Deposit Insurance Corporation (FDIC) the authority to establish and maintain a system—the deposit insurance system—to assess the relative risk of federally insured banks and thrifts and charge them premiums based on that risk. In February 2006, Congress granted FDIC the authority to make substantive changes to the deposit insurance system, including the way the regulator assesses risk and assigns premiums.[7] FDIC issued its final rule implementing changes in November 2006.

[4] 12 U.S.C. § 1831o.

[5] Although section 38 authorizes several noncapital supervisory actions (such as restricting operational activities a regulator determines pose excessive risk to an institution), the discussion of noncapital supervisory actions in this report is limited to actions to dismiss officers and directors under section 38(f)(2)(F) and to reclassify an institution's capital category under section 38(g).

[6] 12 U.S.C. § 1831p-1.

[7] Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109-171, 120 Stat. 9 (2006); Federal Deposit Insurance Conforming Amendments Act of 2005, Pub. L. No. 109-173, 119 Stat. 3601 (2006).

This report responds to the mandate contained in section 6 of the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 requiring the Comptroller General to report on issues relating to the federal banking regulators' administration of the PCA program under section 38 of FDIA as well as various aspects of FDIC's deposit insurance system.[8] Because the banking regulators also monitor the safety and soundness of depository institutions using criteria other than capital levels, this report also includes a review of the federal banking regulators' use of safety and soundness standards under section 39. Specifically, this report (1) describes trends in the financial condition of banks and thrifts and federal regulators' oversight of these institutions since the passage of FDICIA, (2) evaluates how federal regulators have used PCA to resolve capital adequacy issues at the institutions they regulate, (3) evaluates the extent to which federal regulators have used the noncapital supervisory actions of sections 38 and 39 to address weaknesses at the institutions they regulate, and (4) describes FDIC's deposit insurance system and how recent changes to the system affect the determination of institutions' risk and insurance premiums.

To address these objectives, we reviewed relevant laws, regulations, and regulators' policies and procedures and interviewed officials from the four federal banking regulators—FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS)—as well as industry officials and academics. We also reviewed our previous reports on PCA.[9] To describe trends in the financial condition of banks and thrifts and regulators' oversight of these institutions since the passage of FDICIA, we reviewed relevant industry reports and analyses. We also analyzed regulator and industry data to determine, among other things, the number of well-capitalized, adequately capitalized, and undercapitalized institutions and the number of institutions appearing on the problem institutions list since 1992, the year regulators implemented FDICIA.[10] To

[8]Pub. L. No. 109-173, 119 Stat. 3601 (2006).

[9]GAO, *Bank Supervision: Prompt and Forceful Regulatory Actions Needed*, GAO/GGD-91-69 (Washington, D.C.: Apr. 16, 1991), and *Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions*, GAO/GGD-97-18 (Washington, D.C.: Nov. 21, 1996).

[10]Problem institutions typically have severe asset quality, liquidity, and earnings problems that make them potential candidates for failure. FDIC reports the number of problem institutions on its problem institutions list on a quarterly basis.

assess how federal regulators have used PCA to resolve capital adequacy issues at the institutions they regulate, we reviewed section 38 and its implementing regulations, as well as regulators' policies and procedures. We also examined reports of examination, informal and formal enforcement actions, and institution-regulator correspondence for a nonprobability sample of 24 institutions from a population of 157 institutions that fell below one of the three lowest PCA capital thresholds at least once from 2001 through 2005. We chose this period for review based on the availability of examination- and enforcement-related documents and to reflect the most current policies and procedures used by the regulators. The sample reflects a mix of institutions regulated by each of the four regulators as well as a mix of the three lowest PCA capital categories. In 6 of these 24 cases, regulators did not implement PCA because they determined that it was not warranted.[11] In addition, we reviewed the material loss reviews of all banks and thrifts that failed from 1992 through 2005 and in which the primary regulator implemented PCA to address capital adequacy issues.[12] To determine the extent to which federal regulators have used the noncapital supervisory actions of sections 38 and 39 to address weaknesses at the institutions they regulate, we reviewed regulators' policies and procedures related to sections 38(f)(2)(F) and 38(g) (the provisions for dismissal of officers and directors and reclassification of a capital category, respectively) and section 39, as well as data on the number of times and for what purposes they used these noncapital authorities. To provide context on the extent of regulators' use of these noncapital provisions, we also obtained data on the number of times regulators used their authority under section 8(e) of FDIA to remove officers and directors from office and section 8(b) to enforce compliance

[11]In these six cases, regulators did not use PCA for reasons including the following: the institution suffering a onetime drop in reported capital information, the institution misreporting capital information, or the institution failing to meet one or more of the PCA capital ratios by a fraction of a percent.

[12]Section 38(k) of FDIA requires the inspector general of the applicable federal regulator to issue reports on any depository institution whose failure results in a "material loss"—generally losses that exceed $25 million or 2 percent of the institution's assets, whichever is greater—to the deposit insurance fund. These material loss reports must assess why the institution's failure resulted in a material loss and make recommendations for preventing such losses in the future. 12 U.S.C. § 1831o(k).

with safety and soundness standards.[13] Finally, to describe how changes in FDIC's deposit insurance system affect the determination of institutions' risk and insurance premiums, we reviewed FDIC's notice of proposed rule making on deposit insurance assessments, selected comments to the proposed rule, and FDIC's final rule on deposit insurance assessments.[14] We also interviewed representatives of five depository institutions (three large and two small) and two trade groups representing large and small institutions and two academics to obtain their views on the impact of FDIC's changes to the system. Appendix I contains a more detailed description of our scope and methodology. We conducted our work in Washington, D.C., and Chicago from March 2006 through January 2007 in accordance with generally accepted government auditing standards.

Results in Brief

Since the enactment of FDICIA, the financial condition of federally insured depository institutions generally has been strong and regulators have increased their presence at banks and thrifts. Net income and total assets exceeded $133 billion and $10 trillion, respectively, in 2005, and the industry's two primary indicators of profitability—returns on assets and equity—remained near highs at the end of 2005. In this strong economic environment, the percentage of well-capitalized institutions steadily has increased from 94 percent in 1992, the year regulators implemented FDICIA, to just over 99 percent in 2005, while the percentage of well-capitalized institutions with capital in excess of the well-capitalized minimum increased from 84 percent in 1992 to 94 percent in 2005. Over the period, the number of institutions in undercapitalized and lower capital categories experienced a corresponding decline from 1,235 in 1992 to 14 in 2005, and the number of failed institutions also fell dramatically. In addition to requiring regulators to take prompt corrective action against institutions that fail to meet minimum capital requirements, FDICIA also required examiners to conduct annual, on-site examinations at all federally

[13]Section 8(e) (codified at 12 U.S.C. § 1818(e)) gives regulators authority to permanently ban certain institution-affiliated individuals (including officers, directors, and shareholders of an institution) from participating in the conduct of the affairs of any federally regulated institution under certain circumstances involving egregious conduct on the part of the individuals. Section 8(b) (codified at 12 U.S.C. 1818(b)) of FDIA gives regulators authority to order an institution to cease and desist from certain practices or violations.

[14]Federal Deposit Insurance Corporation—Assessments, 71 Fed. Reg. 41910 (2006) (proposed rule). Comments to the proposed rule making were due on September 22, 2006. Federal Deposit Insurance Corporation—Assessments, 71 Fed. Reg. 69282 (2006) (final rule codified at 12 C.F.R. § 327.9, 327.10 and Appendixes A, B, and C of Subpart A).

insured banks and thrifts to improve their ability to identify and address problems in a more timely manner. Although we did not evaluate the regulators' timeliness in conducting examinations, regulatory data show that the average time between examinations fell from a high of 609 days in 1986 to 373 in 1992. Based on information we obtained from all four regulators, the average interval between examinations for all institutions generally has remained from 12 to 18 months since 1993 (the year after FDICIA requirements were implemented) and in many instances, has been even shorter, especially for problem institutions (those with composite CAMELS ratings of 4 or 5).[15]

For the sample of 18 banks and thrifts that were subject to PCA, we found that regulators generally implemented PCA in accordance with section 38, consistent with findings in our 1996 report.[16] For example, regulators identified when each of the institutions failed to meet minimum capital requirements, required these institutions to implement capital restoration plans or corrective actions outlined in enforcement orders, and took steps to close or require the sale or merger of those institutions that were unable to adequately recapitalize. Fifteen of the 18 institutions in our sample remain open or were merged into other institutions or closed without causing losses to the deposit insurance fund, and 3 failed causing losses, one of which was a material loss (that is, a loss exceeding $25 million or 2 percent of an institution's assets, whichever is greater). Although regulators appeared to have used PCA appropriately, capital is a lagging indicator and thus not necessarily a timely predictor of problems at banks and thrifts. All four regulators generally agreed that by design, PCA is not a tool that can be used upon early recognition of a bank or thrift's troubled status. In most cases we reviewed, regulators had responded to safety and soundness problems in advance of a bank or thrift's decline in PCA capital category. For example, each of the 18 institutions subject to PCA appeared on one or more regulatory watch lists prior to or concurrent with experiencing a decline in its capital category, and a majority of the 18 institutions had at least one enforcement action in place prior to becoming undercapitalized. Finally, the inspectors general (IG) of the federal

[15]At each examination, examiners assign a supervisory CAMELS rating, which assesses six components of an institution's financial health: capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. An institution's CAMELS rating is known directly only by the institution's senior management and appropriate regulatory staff. Regulators never publicly release CAMELS ratings, even on a lagged basis.

[16]GAO/GGD-97-18.

banking agencies found that in 12 of 14 cases where regulators used PCA to resolve capital problems at an institution that failed with material losses, the regulators' use of PCA was appropriate. In two cases, the IG found that the regulator could have used PCA sooner than it did.

Regulators have made limited use of noncapital supervisory actions under sections 38 and 39, which allow them to reclassify institutions' capital categories, dismiss officers and directors from deteriorating banks and thrifts, and require institutions to implement plans to address deficiencies in their compliance with regulatory safety and soundness standards. For example, since the implementation of FDICIA, only OCC has used the authority granted under section 38 to reclassify an institution's capital category. According to the regulators, section 38's reclassification provision is of limited use because they can use other enforcement actions to address deficiencies, including capital and noncapital deficiencies (such as deficiencies in asset quality, risk management, and the quality of bank management). These other enforcement actions can be used even when an institution is well capitalized or adequately capitalized by PCA standards. Similarly, since the implementation of FDICIA, regulators made limited use of section 38's dismissal authority—FDIC has made the most frequent use of the authority (six times), while OCC used it once and the Federal Reserve and OTS have never used it. Regulators told us that they often rely on moral suasion to encourage problem officers and directors to resign from institutions, or when an individual's misconduct is severe, they may use their authority under section 8(e) of FDIA to remove that individual from an institution and prohibit him or her from further employment in the industry. FDIC, OCC, and OTS also used section 39 authority in limited circumstances to address safety and soundness deficiencies at the institutions they regulate. However, amendments to section 39 in 1994 increased regulator flexibility over when and how to use the authority and regulators maintain considerable discretion to choose how and when to address safety and soundness weaknesses, as demonstrated by their varied use of noncapital supervisory actions under sections 38 and 39 and other informal and formal enforcement actions. Regulators have used section 39 predominantly to address noncompliance with certain laws or requirements or when management was willing and able to implement required corrective actions, but may not have been responsive to prior informal regulatory criticisms. Regulators told us that they prefer to use formal enforcement actions, such as section 8(b) cease-and-desist orders, to address complex or multiple deficiencies at an institution or in cases where management was not willing or able to quickly implement the required corrective actions.

Recent changes to FDIC's deposit insurance system tie the premiums a bank or thrift pays into the deposit insurance fund more directly to an estimation of the risk that the institution poses to the fund than under the previous system. To do so, FDIC created a system that generally (1) differentiates between larger institutions with current credit agency ratings and $10 billion or more in assets and all other, smaller institutions; (2) for institutions without credit agency ratings, forecasts the likelihood of a decline in financial health; (3) for institutions with credit agency ratings, uses financial market information to evaluate institutional risk; and (4) requires all institutions to pay premiums based on their individual risk.[17] However, FDIC did not completely follow risk-based pricing tenets to set the premiums. Rather, FDIC has chosen to set the base rate premium for the riskiest banks and thrifts at 40 basis points, or 60 percent below the indicated premium of 100, the amount needed to cover expected losses in the event of failure. In doing so, FDIC officials told us they sought to address long-standing concerns of the industry, regulators, and others that premiums should not be set so high as to prevent an institution that is troubled and seeking to rebuild its health from doing so. Most bankers, industry groups, and academics with whom we spoke and many of those organizations that submitted comment letters to FDIC on its new system generally supported FDIC's efforts to make the system more risk based, but many also expressed concerns about certain elements and questioned whether the new system might produce unintended consequences. For example, some were concerned that what they said should be an objective calculation of premiums now will give attention to such subjective factors as the quality of bank management. Others noted that because a bank or thrift receiving a lower CAMELS rating can now expect an increase in premiums, this could create disincentives for bank and thrift management to be cooperative or forthcoming during examinations. FDIC officials said that FDIC, along with the other federal regulators, plans to monitor the new system for adverse effects.

We provided a draft of this report to FDIC, the Federal Reserve, OCC, and OTS for their review and comment. In written comments, the Federal Reserve concurred with our findings relating to PCA (see app. II). In addition, FDIC, the Federal Reserve, and OCC provided technical comments, which we incorporated as appropriate.

[17]Credit rating agencies, such as Moody's Investors Services, Standard & Poor's, and Fitch Ratings, evaluate an institution's ability to repay debt and then publish a rating reflecting their opinion on that institution's likelihood of default.

Background

Four federal banking regulators—FDIC, the Federal Reserve, OCC, and OTS—oversee the nation's banks and thrifts to ensure they are operating in a safe and sound manner. The failure of more than 2,900 depository institutions during the 1980s and early 1990s led to the passage of FDICIA, which amended FDIA to require regulators to take action against institutions that failed to meet minimum capital levels and granted regulators several authorities to address noncapital deficiencies at the institutions they regulate. FDICIA also required FDIC to establish a system to assess the risk of depository institutions insured by the deposit insurance fund.

Federal Regulation of Banks and Thrifts

FDIC insures the deposits of all federally insured depository institutions, generally up to $100,000 per depositor, and monitors their risk to the deposit insurance fund. In addition, FDIC is the primary regulator for state-chartered nonmember banks (that is, state-chartered banks that are not members of the Federal Reserve System), the Federal Reserve is the primary regulator for state-chartered member banks (state-chartered banks that are members of the Federal Reserve System) and bank holding companies, OCC is the primary regulator of federally chartered banks, and OTS is the primary regulator of federally and state-chartered thrifts and thrift holding companies.[18]

Federal regulators have defined several categories of risk to which depository institutions are exposed—credit risk, compliance risk, legal

[18]This report only addresses the extent to which regulators used sections 38 and 39 to address problems at banks and thrifts. Bank and thrift holding companies are excluded from all discussion and data. Under the dual federal and state banking system, state-chartered banks are supervised jointly by their state chartering authority and either FDIC or the Federal Reserve. OCC and OTS are operating bureaus under the Department of the Treasury.

risk, liquidity risk, market risk, operational risk, reputational risk, and strategic risk (see table 1).[19]

Table 1: Definitions of Risk

Risk	Definition
Compliance	The risk arising from violations of or nonconformance with laws, rules, regulations, prescribed practices, or ethical standards.
Credit	The risk that a borrower or counterparty to a transaction will default on an obligation.
Legal	The risk that potential unenforceable contracts, lawsuits, or adverse legal judgments could negatively affect the operations or condition of an institution.
Liquidity	The risk arising from an institution's inability to meet its obligations when they come due because of an inability to liquidate assets or obtain adequate funding.
Market	The risk arising from adverse movement in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
Operational	The risk that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in losses.
Reputational	The risk that potential negative publicity regarding an institution's business practices could cause a decline in the customer base, costly litigation, or revenue reductions.
Strategic	The risk arising from adverse business decisions or improper implementation of those decisions, improper business planning, or inadequate responses to changes in the industry.

Source: GAO.

Banks and thrifts, in conjunction with regulators, must continually manage risks to ensure their safe and sound operation and protect the well-being of depositors—those individuals and organizations that act as creditors by "loaning" their funds in the form of deposits to institutions to engage in

[19]Within these categories, we and others have identified and reported on several specific risks currently facing the industry, including the growth in alternative mortgage products and increasing concentrations of commercial real estate holdings among certain institutions. See GAO, *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved*, GAO-06-1021 (Washington, D.C.: Sept. 19, 2006); Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, 71 Fed. Reg. 74585 (2006) (joint final guidance); and Office of Thrift Supervision, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, 71 Fed. Reg. 75298 (2006) (final guidance).

lending and other activities. Regulators are responsible for supervising the activities of banks and thrifts and taking corrective action when these activities and their overall performance present supervisory concerns or have the potential to result in financial losses to the insurance fund or violations of law. Losses to the insurance fund may occur when an institution does not have sufficient assets to reimburse customers' insured deposits and FDIC's administrative expenses in the event of closure or merger.

Regulators assess the condition of banks and thrifts through off-site monitoring and on-site examinations. Examiners use Reports of Condition and Income (Call Report) and Thrift Financial Report data to remotely assess the financial condition of banks and thrifts, respectively, and to plan the scope of on-site examinations.[20] As part of on-site examinations, regulators more closely assess institutions' exposure to risk and assign institutions ratings, known as CAMELS ratings, that reflect their condition in six areas: capital, asset quality, management, earnings, liquidity, and sensitivity to market risk.[21] Each component is rated on a scale of 1 to 5, with 1 the best and 5 the worst. The component ratings then are used to develop a composite rating also ranging from 1 to 5. Institutions with composite ratings of 1 or 2 are considered to be in satisfactory condition, while institutions with composite ratings of 3, 4, or 5 exhibit varying levels of safety and soundness problems. Also as part of the examination and general supervision process, regulators may direct an institution to address issues or deficiencies within specified time frames.

When regulators determine that a bank or thrift's condition is unsatisfactory, they may take a variety of supervisory actions, including informal and formal enforcement actions, to address identified deficiencies and have some discretion in deciding which actions to take. Regulators typically take progressively stricter actions against more serious weaknesses. Informal actions generally are used to address less severe deficiencies or when the regulator has confidence that the institution is willing and able to implement changes. Informal actions include, for example, commitment letters detailing an institution's

[20]All banks that FDIC insures must submit quarterly Call Reports, which contain a variety of financial information, including capital ratios, that show a bank's condition and income. Thrifts file similar reports, called Thrift Financial Reports.

[21]Effective January 1, 1997, the Federal Financial Institutions Examination Council added the "S" component of the CAMELS rating; prior to 1997, the rating was known as CAMEL.

commitment to undertake specific remedial measures, board resolutions adopted by the institution's board of directors at the request of its regulator, and memorandums of understanding. Informal actions are not public agreements (meaning, regulators do not make them public through their Web sites or other channels) and are not enforceable by the imposition of sanctions.[22] In comparison, formal enforcement actions are publicly disclosed by regulators and enforceable and are used to address more severe deficiencies or when the regulator has limited confidence in an institution's ability to implement changes. Formal enforcement actions include, for example, PCA directives, cease-and-desist orders under section 8(b) of FDIA, removal and prohibition orders under section 8(e) of FDIA, civil money penalties, and termination of an institution's deposit insurance.[23]

All four regulators have policies and procedures that describe for examiners the circumstances under which they should recommend the use of informal and formal enforcement actions to address identified deficiencies. Each federal banking regulator also has established a means through which senior management of the applicable federal regulator reviews all enforcement recommendations to ensure that the proposed actions are the best and most efficient means to bring an institution back into compliance with applicable laws, regulations, and best practices.

Capital and Noncapital Actions of FDIA

Section 38 of FDIA requires regulators to categorize depository institutions into five categories on the basis of their capital levels. Regulators use three different capital measures to determine an institution's capital category: (1) a total risk-based capital measure, (2) a tier 1 risk-based capital measure, and (3) a leverage (or non-risk-based) capital measure (see table 2). To be considered well capitalized or adequately capitalized, an institution must meet or exceed all three ratios for the applicable capital category. Institutions are considered undercapitalized or worse if they fail to meet just one of the ratios

[22]Noncompliance with an informal enforcement action can be addressed by a formal action under section 8 of FDIA.

[23]PCA directives are formal actions that regulators issue to institutions that fail to meet minimum capital requirements. Directives require institutions to take one or more specified actions to return to required minimum capital standards. Regulators typically use directives to specify corrective actions for significantly and critically undercapitalized institutions, as the restrictions and requirements specified in section 38 for undercapitalized institutions are automatic.

necessary to be considered at least adequately capitalized. For example, an institution with 9 percent total risk-based capital and 6 percent tier 1 risk-based capital but only 3.5 percent leverage capital would be undercapitalized for PCA purposes.

Table 2: PCA Capital Categories

Capital category	Total risk-based capital[a]	Tier 1 risk-based capital	Leverage capital[b]
Well capitalized[c]	10% or more and	6% or more and	5% or more
Adequately capitalized	8% or more and	4% or more and	4% or more[d]
Undercapitalized	Less than 8% or	Less than 4% or	Less than 4%
Significantly undercapitalized	Less than 6% or	Less than 3% or	Less than 3%
Critically undercapitalized	An institution is critically undercapitalized if its tangible equity is 2% or less regardless of its other capital ratios.[e]		

Sources: Capital measures and capital category definitions: FDIC—12 C.F.R. § 325.103 (2006), Federal Reserve—12 C.F.R. § 208.43 (2006), OCC—12 C.F.R. § 6.4 (2006), and OTS—12 C.F.R. § 565.4 (2006).

[a]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.

[b]Leverage capital is tier 1 capital divided by average total assets.

[c]An institution that satisfies the capital measures for a well-capitalized institution but is subject to a formal enforcement action that requires it to meet and maintain a specific capital level is considered to be adequately capitalized for purposes of PCA.

[d]CAMELS 1-rated institutions not experiencing or anticipating significant growth need only have 3 percent leverage capital to be considered adequately capitalized.

[e]Tangible equity is equal to the amount of core capital elements plus outstanding perpetual preferred stock minus all intangible assets not previously deducted, except certain purchased mortgage-servicing rights.

Under section 38, regulators must take increasingly severe supervisory actions as an institution's capital level deteriorates. For example, all undercapitalized institutions are required to implement capital restoration plans to restore capital to at least the adequately capitalized level, and regulators are generally required to close critically undercapitalized institutions within a 90-day period. Section 38 allows an exception to the 90-day closure rule if both the primary regulator and FDIC concur and document why some other action would better achieve the purpose of section 38—resolving the problems of institutions at the least possible long-term cost to the deposit insurance fund.

Resolving failed or failing institutions is one of FDIC's primary responsibilities under PCA. In selecting the least costly resolution alternative, FDIC's process is to compare the estimated cost of liquidation—basically, the amount of insured deposits paid out minus the net realizable value of an institution's assets—with the amounts that potential acquirers bid for the institution's assets and deposits. FDIC has resolved failed or failing institutions using three basic methods: (1) directly paying depositors the insured amount of their deposits and disposing of the failed institution's assets (depositor payoff and asset liquidation); (2) selling only the institution's insured deposits and certain other liabilities, with some of its assets, to an acquirer (insured deposit transfer); and (3) selling some or all of the failed institution's deposits, certain other liabilities, and some or all of its assets to an acquirer (purchase and assumption). Within this third category, many variations exist based on specific assets that are offered for sale. For example, some purchase and assumption resolutions also have included loss-sharing agreements—an arrangement whereby FDIC, in order to sell certain assets with the intent of limiting losses to the deposit insurance fund, agrees to share with the acquirer the losses on those assets.

Section 38 also authorizes several non-capital-based supervisory actions designed to allow regulators some flexibility in achieving the purpose of section 38. Specifically, under section 38(g) regulators are permitted to reclassify or downgrade an institution's capital category to apply more stringent operating restrictions or requirements if they determine, after notice and opportunity for a hearing, that an institution is in an unsafe and unsound condition or engaging in an unsafe or unsound practice. Under section 38(f)(2)(F) regulators can require an institution to make improvements in management, for example, by dismissing officers and directors who are not able to materially strengthen an institution's ability to become adequately capitalized.[24]

Section 39 directs regulatory attention to noncapital areas of an institution's operations and activities in three main safety and soundness areas: operations and management; compensation; and asset quality, earnings, and stock valuation. As originally enacted under FDICIA, section 39 required regulators to develop and implement standards in these three areas, as well as develop quantitative standards for asset quality and earnings. However, in response to concerns about the potential regulatory burden of section 39 on banks and thrifts, section 318 of the Riegle Community Development and Regulatory Improvement Act of 1994

[24]Under section 38(f)(2)(F), regulators also may order a new election for an institution's board of directors or require the institution to employ qualified senior executive officers.

amended section 39 to allow the standards to be issued either by regulation (as originally specified in FDICIA) or by guideline and eliminated the requirement to establish quantitative standards for asset quality and earnings.[25] The regulators chose to prescribe the standards through guideline rather than regulation, essentially providing them with flexibility in how and when they would take action against institutions that failed to meet the standards.[26] Under section 39, if a regulator determines that an institution has failed to meet a prescribed standard, the regulator may require that the institution file a safety and soundness plan specifying the steps it will take to correct the deficiency.[27] If the institution fails to submit an acceptable plan or fails to materially implement or adhere to an approved plan, the regulator must require the institution, through the issuance of a public order, to correct identified deficiencies and may take other enforcement actions pending the correction of the deficiency.

Deposit Insurance System

In addition to adding sections 38 and 39 to FDIA to address capital inadequacy and safety and soundness problems at depository institutions, FDICIA also required FDIC to establish a system—the deposit insurance system—to assess the risk of federally insured depository institutions and charge premiums to finance a deposit insurance fund meant to protect depositors in the event of future bank and thrift failures.

At the urging of FDIC, in February 2006 Congress enacted legislation granting the regulator authority to make substantive changes to the deposit insurance system, including the way it assesses the risk of institutions and determines their premiums. In July 2006, FDIC issued its proposed rule outlining proposed changes to the deposit insurance system and opened a public comment period. FDIC adopted a final rule in November 2006. Recalculated premiums and other changes reflected in the final rule were effective January 1, 2007. As of September 30, 2006, FDIC insured over 60 percent of all domestic deposits, totaling more than $4 trillion.

[25] Pub. L. No. 103-325, 18 Stat. 2160, 2223-2224 (1994).

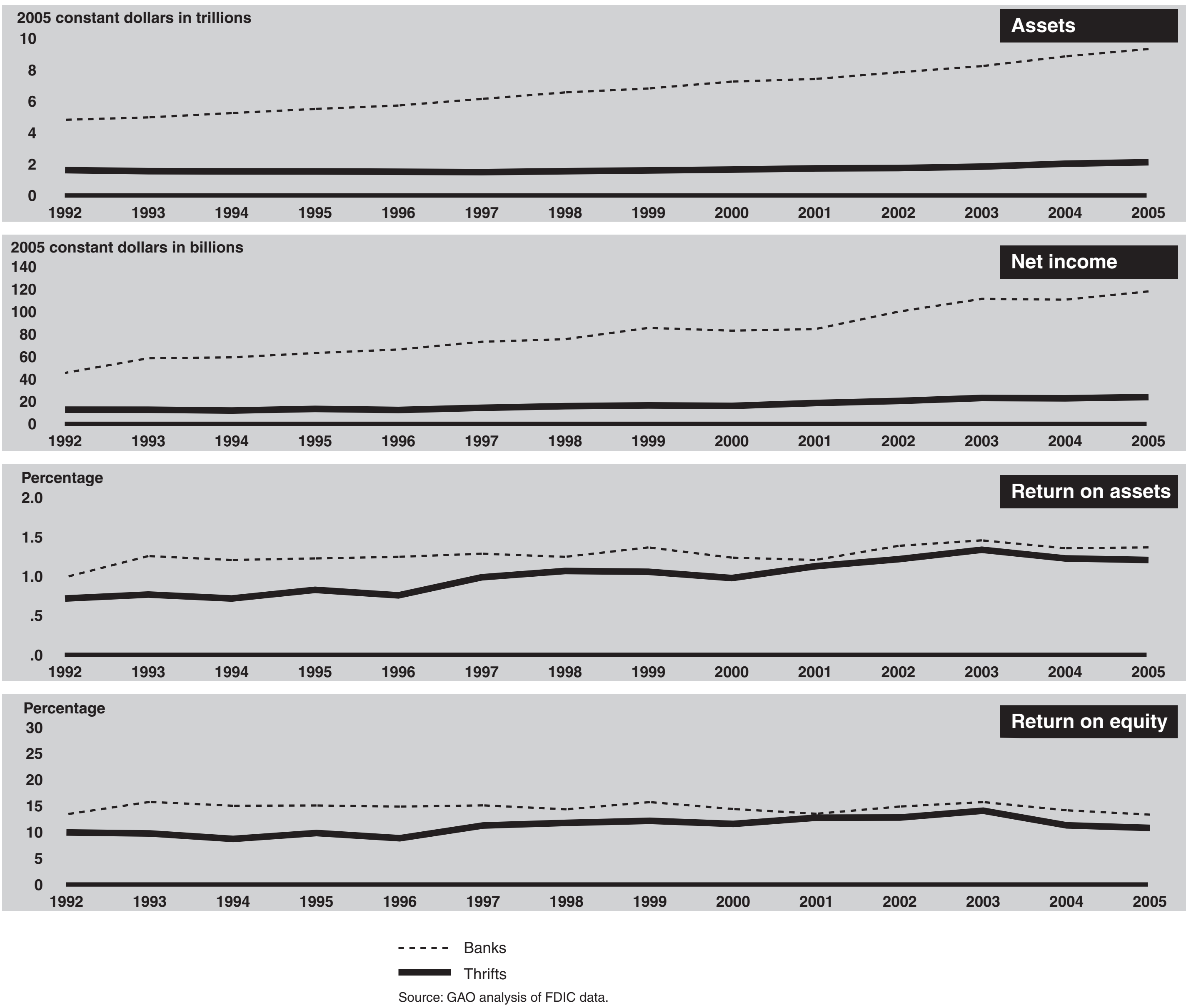
[26] Interagency Guidelines Establishing Standards for Safety and Soundness, 60 Fed. Reg. 35680 (1995) (codified as amended as follows: FDIC—Appendix A to 12 C.F.R. pt. 364 (2006); Federal Reserve—Appendix D-1 to 12 C.F.R. pt. 208 (2006); OCC—Appendix A to 12 C.F.R. pt. 30 (2006); and OTS—Appendix A to 12 C.F.R. pt. 570 (2006)).

[27] 12 U.S.C. § 1831p-1(e).

Since the Enactment of FDICIA, the Financial Condition of Depository Institutions Has Been Strong and Regulators' On-site Monitoring Has Been More Frequent

The nation's banks and thrifts have benefited from a strong economy since 1992—as demonstrated by steady increases in several of the industry's primary performance indicators and growing numbers of institutions meeting or exceeding minimum capital levels. For example, in 2005, the industry reported record total assets ($10 trillion in 2005) and net income ($133 billion in 2005) (see fig. 1). Similarly, the industry's two primary indicators of profitability—returns on assets and equity—have improved since 1992 and remain near record highs.

Figure 1: Total Assets, Total Net Income, Return on Assets, and Return on Equity for Federally Insured Commercial Banks and Savings Institutions, 1992-2005



Source: GAO analysis of FDIC data.

As a result of institutions' overall strong financial performance, few have failed to meet minimum capital requirements since 1992, the year regulators implemented PCA. The percentage of well-capitalized institutions has increased from 93.99 percent in 1992 to 99.71 percent in 2005, while the percentage of undercapitalized and lower-rated institutions generally has declined (see fig. 2). For example, the percentage of significantly undercapitalized institutions declined from 2.74 percent (394 institutions) to 0.06 percent (5 institutions) in this period, while the percentage of critically undercapitalized institutions fell from 1.64 percent to 0.01 percent (236 to 1).[28]

Figure 2: Number and Percentage of Institutions in PCA Capital Categories, 1992-2005

		Percentage and number of reporting institutions by capitalization category									
Year	Reporting institutions	Well capitalized		Adequately capitalized		Undercapitalized		Significantly undercapitalized		Critically undercapitalized	
1992	14,399	93.99%	13,534	11.08%	1,596	4.20%	605	2.74%	394	1.64%	236
1993	13,741	97.85	13,445	5.08	698	1.43	196	1.01	139	.41	57
1994	13,136	98.74	12,971	3.51	461	.68	89	.45	59	.18	24
1995	12,448	99.21	12,350	2.96	369	.51	63	.26	32	.14	18
1996	11,971	99.29	11,886	3.18	381	.41	49	.18	21	.09	11
1997	11,499	99.21	11,408	3.69	424	.32	37	.23	26	.12	14
1998	10,973	99.21	10,886	3.99	438	.55	60	.19	21	.09	10
1999	10,594	99.09	10,498	4.29	454	.36	38	.21	22	.11	12
2000	10,319	99.14	10,230	4.42	456	.27	28	.16	17	.06	6
2001	9,931	99.21	9,853	4.23	420	.40	40	.17	17	.15	15
2002	9,598	99.40	9,540	3.82	367	.36	35	.17	16	.15	14
2003	9,406	99.70	9,378	2.63	247	.20	19	.15	14	.14	13
2004	9,217	99.73	9,192	2.30	212	.09	8	.08	7	.05	5
2005	9,077	99.71	9,051	1.89	172	.09	8	.06	5	.01	1

Source: GAO analysis of Call and Thrift Financial Report data.

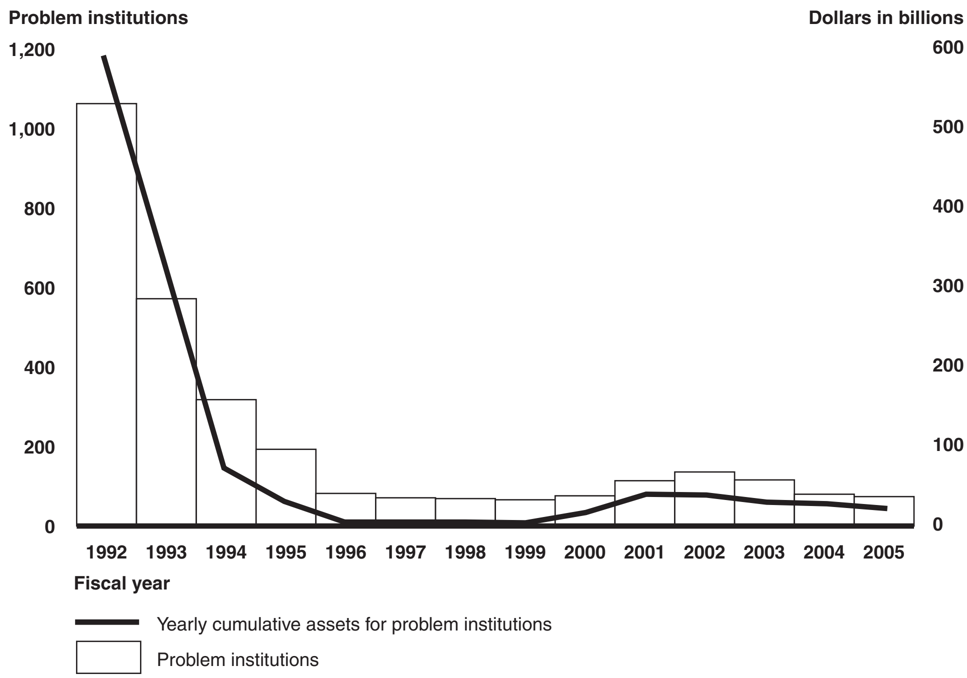
[28]We counted the institutions in each PCA capital category by quarter because institutions are required to report capital ratio information in quarterly Call and Thrift Financial Reports. As a result, the number of institutions in each category per year is more than the number of institutions reporting in each year because an institution could appear in more than one capital category in a year. Thus, the percentage of institutions in all five capital categories in a given year is more than 100 percent.

Further, the percentage of institutions carrying capital in excess of the well-capitalized leverage capital minimum (that is, 5 percent or more of leverage capital) also increased from 84 percent of all reporting institutions in 1992 to 94 percent in 2005.[29] The percentage of institutions carrying at least two times as much capital (200 percent or more of the well-capitalized leverage capital minimum) increased from 25 percent to 41 percent over the period.

According to regulators, the improved financial condition of banks and thrifts may have contributed to the sharp decline in the number of problem institutions (those with composite CAMELS ratings of 4 or 5), from 1,063 in 1992 to 74 in 2005 (see fig. 3).

[29]To determine those institutions that held capital in excess of the well-capitalized minimum, we first determined the number of institutions that were well capitalized for all four quarters of each calendar year, 1992 through 2005, and then calculated the average amount of leverage capital each of the institutions held during each calendar year.

Figure 3: Number of Problem Institutions and Total Assets, 1992-2005

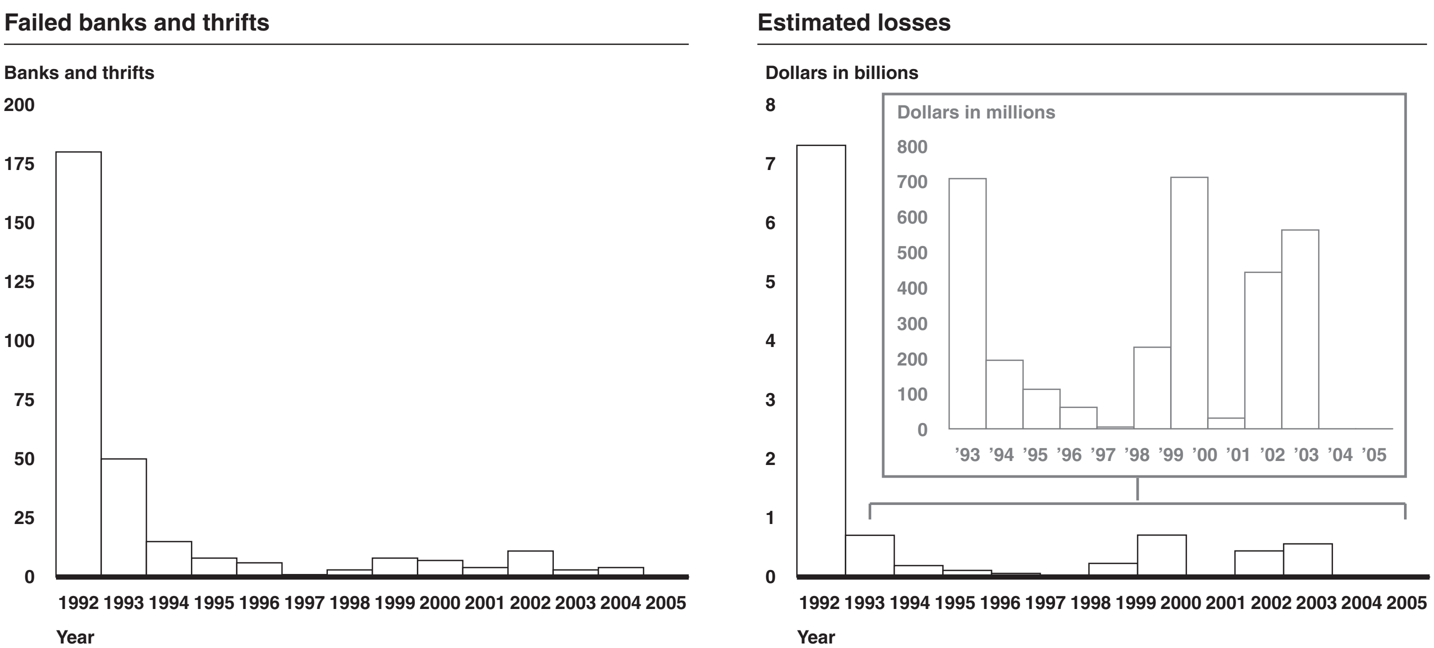


Source: GAO analysis of FDIC data.

Similarly, regulators said that institutions' improved financial condition may have also contributed to the significant decline in the number of failures and losses to the insurance fund since 1992 (see fig. 4). From 1992 through 2004, the number of failed banks and thrifts fell from 180 (with estimated losses to the insurance fund of $7.3 million) to 4 (with no estimated losses). No bank or thrift failed from June 2004 through January 2007.[30]

[30]Metropolitan Savings Bank, Pittsburgh, Pennsylvania, failed on February 2, 2007; however, because this failure occurred after we completed our audit work, we did not include this bank in our discussion of failed institutions.

Figure 4: Failed Banks and Thrifts and Their Estimated Losses, 1992-2005



Source: GAO analysis of FDIC data.

In addition, regulators' on-site presence at banks and thrifts increased beginning in the early 1990s, in part as a result of reforms enacted as a part of FDICIA that required regulators to conduct full-scope, on-site examinations for most federally insured institutions at least annually to help contain losses to the deposit insurance fund.[31] Historical data show that the interval between full-scope, on-site examinations for all institutions peaked in 1986 when it reached 609 days. Subsequent to the enactment of FDICIA in December 1991, the average interval between

[31]Pub. L. No. 102-242 § 111(a), 105 Stat. 2236, 2240 (1991) (codified as amended at 12 U.S.C. § 1820(d)). Section 605 of the Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, 120 Stat. 1966, 1981 (2006) amended section 10(d)(4)(A) of FDIA (codified at 12 U.S.C. § 1820(d)(4)(A)) to provide that for well-capitalized, well-managed institutions with total assets of less than $500 million that are not subject to an enforcement action or any change in control during the 12-month period in which a full-scope, on-site examination would be required, regulators are only required to conduct an on-site examination every 18 months.

examinations for all institutions declined to 373 days in 1992.[32] Based on information we obtained from all four regulators, the average interval between examinations for all institutions generally has remained from 12 to 18 months since 1993 (the year after FDICIA requirements were implemented) and in many instances has been even shorter, especially for problem institutions.

Regulators Used PCA Appropriately in Cases We Reviewed and Other Enforcement Actions Generally Preceded Declines in These Institutions' PCA Capital Categories

For the sample of banks and thrifts we reviewed, we found that regulators generally implemented PCA in accordance with section 38. For example, when institutions failed to meet minimum capital requirements, regulators required them to submit capital restoration plans or imposed restrictions through PCA directives or other enforcement actions. Regulators generally agreed that capital is a lagging indicator of poor performance and therefore other measures are often used to address deficiencies upon recognition of an institution's troubled status. This contention was supported by the fact that in a majority of the cases we reviewed, institutions had one or more informal or formal enforcement actions in place prior to becoming undercapitalized. Most of the material loss reviews conducted by IGs also found that regulators appropriately used PCA provisions in most cases, although in two reviews they found that regulators could have used PCA sooner.

Regulators Used PCA Appropriately to Resolve Capital Problems at Banks and Thrifts We Reviewed

Based on a sample of cases, we found that regulators generally acted appropriately to address problems at institutions that failed to meet minimum capital requirements by taking increasingly severe enforcement actions as these institutions' capital deteriorated, as required by section 38.

[32] Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future* (Washington, D.C.: 1997). FDIC data include only those institutions that FDIC, the Federal Reserve, and OCC supervise. According to OTS data, the average number of days between examinations was 461 in 1989, the year OTS was formed, and down to 309 days by 1992.

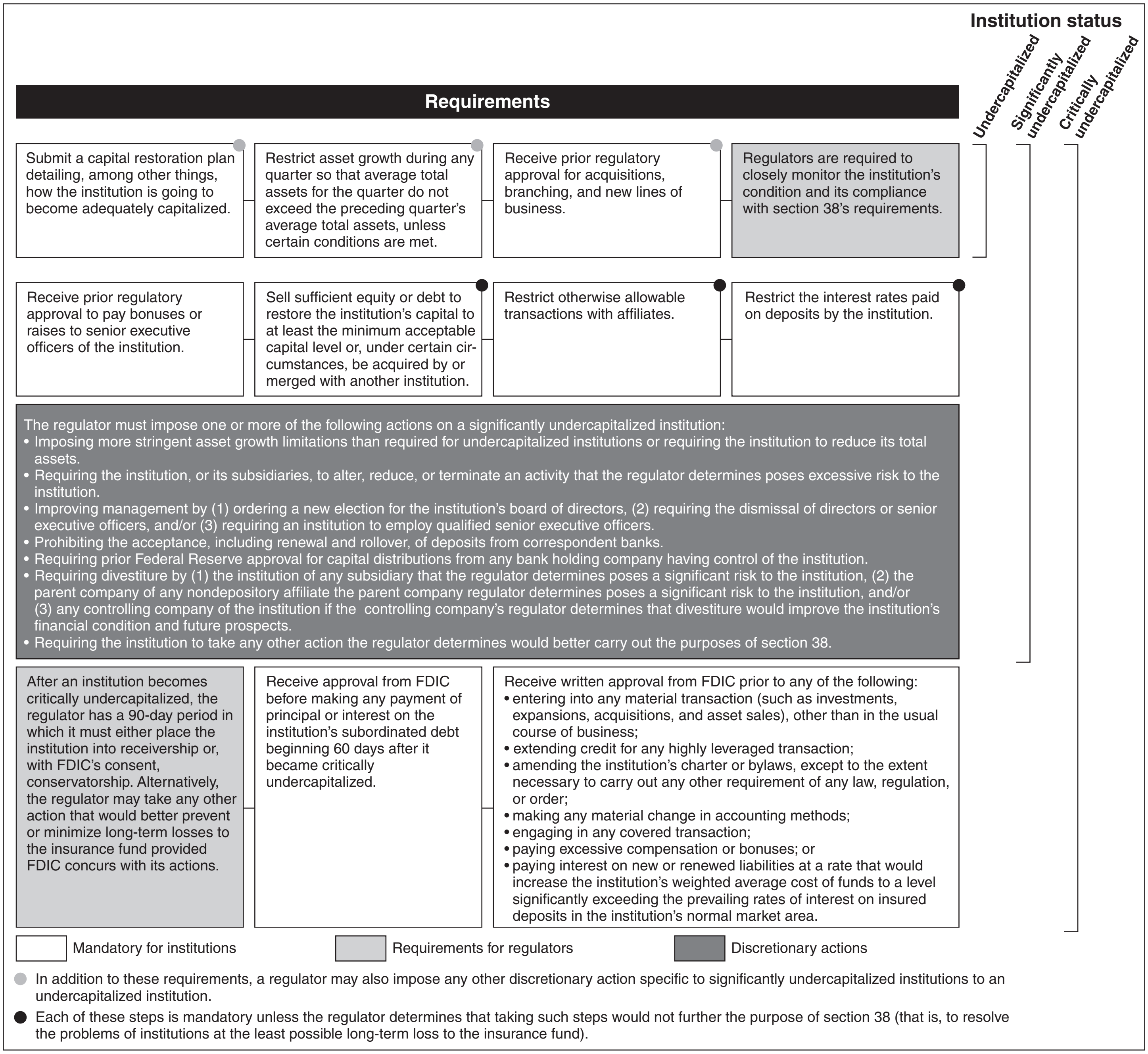
PCA Requires Regulators to Take Specific Actions When Capital Declines

Institutions that fail to meet minimum capital levels face several mandatory restrictions or requirements under section 38 (see fig. 5).[33] Specifically, section 38 requires an undercapitalized institution to submit a capital restoration plan detailing how it is going to become adequately capitalized. When an institution becomes significantly undercapitalized, regulators are required to take more forceful corrective measures, including requiring the sale of equity or debt, or under certain circumstances requiring an institution to be acquired by or merged with another institution; restricting otherwise allowable transactions with affiliates; and restricting the interest rates paid on deposits. In addition to these actions, regulators also may impose other discretionary restrictions or requirements outlined in section 38 that they deem appropriate. After an institution becomes critically undercapitalized, regulators have 90 days to either place the institution into receivership or conservatorship (that is, close the institution) or to take other actions that would better prevent or reduce long-term losses to the insurance fund.[34] Regulators also have some discretion in how they enforce PCA restrictions and requirements—they may issue a PCA directive (a formal action that requires an institution to take one or more specified actions to return to required minimum capital standards) or delineate the restrictions and requirements in a new or modified enforcement order, such as a section 8(b) cease-and-desist order.

[33]With one exception, section 38 does not place restrictions on institutions that are well capitalized or adequately capitalized. Namely, all institutions, regardless of their capital level, are prohibited from paying dividends or management fees that would drop them into the undercapitalized category. Further, section 301 of FDICIA amended section 29 of FDIA (codified at 12 U.S.C. § 1831f) to allow adequately capitalized institutions to accept or renew brokered deposits only if they receive waivers from FDIC. (Brokered deposits are large-denomination deposits that a broker divides into smaller pieces to sell to multiple depository institutions on behalf of its customers.) Section 301 also imposes certain interest rate restrictions for brokered deposits accepted by institutions that are not well capitalized.

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

Figure 5: Section 38 Mandatory and Discretionary Requirements



Source: 12 C.F.R. Parts 308 and 325, September 29, 1992.

Regulators Used PCA Appropriately at the Banks and Thrifts We Reviewed

For the cases we reviewed, consistent with our 1996 report, we found that regulators generally implemented PCA in accordance with section 38, the implementing regulations, and their policies and procedures.[35] Regulators used PCA to address capital problems at 18 of 24 institutions we sampled from among those that fell below one of the three lowest PCA capital thresholds (that is, undercapitalized, significantly undercapitalized, or critically undercapitalized based on Call or Thrift Financial Report data). (See table 3.)

Table 3: Sampled Institutions with PCA Taken to Address Capital Deficiencies

Institution name	Primary regulator	PCA capital category[a]
Pulaski Savings Bank	FDIC	Critically undercapitalized
Rock Hill Bank and Trust	FDIC	Critically undercapitalized
FDIC Open Bank 1	FDIC	Significantly undercapitalized
FDIC Open Bank 2	FDIC	Significantly undercapitalized
CIB Bank	FDIC	Undercapitalized
Southern Pacific Bank	FDIC	Undercapitalized
Deuel County State Bank	Federal Reserve	Critically undercapitalized
New Century Bank	Federal Reserve	Critically undercapitalized
Federal Reserve Open Bank 1	Federal Reserve	Significantly undercapitalized
Federal Reserve Open Bank 2	Federal Reserve	Significantly undercapitalized
Bank of Greenville	Federal Reserve	Undercapitalized
Harbor Bank	OCC	Critically undercapitalized
Compubank	OCC	Significantly undercapitalized
First National Bank (Lubbock)	OCC	Undercapitalized
Georgia Community Bank	OTS	Critically undercapitalized
OTS Open Thrift 1	OTS	Significantly undercapitalized
First Heights Bank FSB	OTS	Significantly undercapitalized
Enterprise FSB	OTS	Undercapitalized

Source: GAO analysis of Call and Thrift Financial Report data.

[35] GAO/GGD-97-18. Our 1996 report on the implementation of PCA found that regulators generally took prescribed enforcement actions under section 38, including obtaining and reviewing capital restoration plans from undercapitalized institutions and closing critically undercapitalized institutions within the required 90-day time frame.

[a]We do not name institutions that are still active, but refer to them by regulator and number. We selected institutions for our sample randomly by regulator and by capital category (based on Call and Thrift Financial Report data) so that the numbers of institutions regulated by each of the regulators and numbers of institutions in each of the capital categories generally were equal. An institution's capital category as listed in this table does not necessarily reflect the only capital category in which it appeared, based on Call or Thrift Financial Report data, during the period of our review (2001-2005); rather it represents the capital category from which it was selected for the sample.

In each of the 18 cases in which regulators used PCA to address capital deficiencies, the relevant regulator identified the institution as having fallen below one of the three lowest PCA capital thresholds and in most cases required the institution to address deficiencies through a capital restoration plan or a PCA directive or other enforcement order.

Regulators' use of PCA is illustrated by the following examples:

- From the end of March 2002 to the end of June 2002, Rock Hill Bank and Trust's capital level declined from well capitalized to critically undercapitalized. In response, FDIC issued a notice informing the bank of the restrictions applicable to critically undercapitalized institutions under section 38. Within approximately 2 months of first becoming critically undercapitalized, the bank entered into a purchase and assumption agreement with another institution.

- Federal Reserve examiners required Federal Reserve Open Bank 2 to submit a capital restoration plan more than a year and a half prior to the bank's failure to meet minimum capital requirements. Federal Reserve examiners, prepared to issue a PCA directive when the bank's capital fell to significantly undercapitalized in March 2005, noted in a June 2005 report of examination that the bank had taken steps to raise its capital level to undercapitalized, and then issued a PCA directive requiring the bank to submit a capital restoration plan. By September 2005, the bank was well capitalized by PCA standards.

- OCC examiners notified First National Bank (Lubbock) of its critically undercapitalized status shortly after the closing date of the bank's June 30, 2003, Call Report filing. In November 2003, the bank was sold to a bank holding company and recapitalized. Concurrent with the bank's June 30, 2004, Call Report filing date, OCC conducted a full-scope examination and found the bank to be critically undercapitalized and directed it to file a capital restoration plan. The bank merged into an affiliate in early 2005, in accordance with its capital restoration plan.

- After Enterprise FSB's capital level declined to undercapitalized in September 2001, OTS issued a PCA directive that required the institution to submit a capital restoration plan and make arrangements to sell or merge with another institution. On several occasions, OTS modified its original PCA directive to allow additional time to process the institution's merger application. With the exception of one quarter in which Enterprise FSB's capital level increased to well capitalized, the institution remained undercapitalized until the merger was completed in early 2003.

Regulators said that PCA was most effective when it was used to close or require the sale or merger of institutions as a means of minimizing or preventing losses to the insurance fund. Fifteen of the 18 institutions we reviewed were able to recapitalize or merged or closed without losses to the insurance fund. The remaining three institutions failed with losses to the insurance fund: Pulaski Savings Bank ($1 million), New Century Bank ($5 million), and Southern Pacific Bank ($93 million). The failure of Southern Pacific Bank resulted in material losses to the insurance fund. In its material loss review for the bank, the FDIC IG noted that even though FDIC examiners applied PCA in accordance with regulatory guidelines, other factors, including the bank's failure to abide by FDIC recommendations related to the administration of its loan program, resulted in an overstatement of both net income and capital and limited PCA's effectiveness in minimizing losses to the insurance fund. In our review of FDIC's reports of examination and other information for the bank, we found that FDIC examiners continually informed the bank of its capital status and made repeated requests to management to recapitalize. However, the bank's reported capital level never fell to critically undercapitalized—the point at which FDIC has the authority to close an institution under section 38.

In 6 of the 24 sampled cases we reviewed, we determined that use of PCA was not required to address declines in capital reported on quarterly Call and Thrift Financial Reports (see table 4).

Table 4: Sampled Institutions Where Use of PCA Was Not Required

Institution name	Primary regulator	Reason regulator did not use PCA to address decline in capital category
First Bank of Texas	FDIC	First Bank of Texas was in the process of merging into another institution when it became undercapitalized for one quarter. The bank did not present any capital or supervisory concerns prior to its merger.
Madison Bank	Federal Reserve	Madison Bank experienced an operating loss as a result of a pending merger, which caused it to become undercapitalized for one quarter. The loss and impact on capital were reported after the institution merged, thus Federal Reserve examiners did not apply PCA.
First National Bank of Springdale	OCC	First National Bank of Springdale became critically undercapitalized for one quarter that coincided with its merger into another institution. The bank presented no supervisory concerns at that time.
Household Bank of Nevada	OCC	Household Bank of Nevada was significantly undercapitalized on two occasions because it miscalculated capital ratio information. OCC officials told us that during this period, the bank had other safety and soundness weaknesses rather than capital problems. Therefore, OCC, in conjunction with FDIC and OTS, took steps to consolidate Household Bank and other subsidiaries of the bank's parent company so that they could be acquired by another institution.
Century Bank	OCC	Century Bank failed to meet the total risk-based capital requirement for only one quarter and only by a fraction of a percent (0.01 percent). The bank was otherwise well capitalized and did not have any other indicators that it was a troubled institution during this period.
OTS Open Thrift 2	OTS	OTS Open Thrift 2 was undergoing a reorganization that involved the issuance of stock. The issuance was oversubscribed, causing the thrift's tier 1 leverage capital to fall below the required minimum and appear as undercapitalized for one quarter. The thrift did not present any capital or supervisory concerns before or after the stock issuance.

Source: GAO analysis of regulatory data.

Regulators Used Other Enforcement Actions to Address Deficiencies in Sampled Institutions Prior to Declines in Their PCA Capital Categories

Although PCA requires regulators to take regulatory action when an institution fails to meet established minimum capital requirements, capital is a lagging indicator and thus not necessarily a timely predictor of problems at banks and thrifts. Although capital is an essential and accepted measure of an institution's financial health, it does not typically begin to decline until an institution has experienced substantial deterioration in other areas, such as asset quality and the quality of bank management. As a result, regulatory actions focused solely on capital may have limited effects because of the extent of deterioration that may have already occurred in other areas. All four regulators generally agreed that by design, PCA is not a tool that can be used upon early recognition of an institution's troubled status—in all of the cases we examined, regulators took steps, in addition to PCA, to address institutions' troubled conditions.

For example, 12 of the 18 banks and thrifts subject to PCA that we examined experienced a decline in their CAMELS ratings to composite ratings of 4 or 5 prior to or generally concurrent with becoming undercapitalized. CAMELS ratings measure an institution's performance in six areas—capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. These ratings are a key product of regulators' on-site monitoring of institutions, providing information on the condition and performance of banks and thrifts, and can be useful in predicting their failure. The FDIC IG found a similar trend among the banks it examined as part of an evaluation of FDIC's implementation of PCA.[36]

All of the 18 institutions we examined also appeared on at least one of three regulator watch lists—the FDIC problem institutions list, the FDIC resolution cases list, and the FDIC projected failure list—prior to or concurrent with becoming undercapitalized (see fig. 6).[37] Regulators use these and their own watch lists to monitor the status of troubled institutions and, in some cases, ensure their timely resolution (that is, facilitating the merger or closure of institutions to prevent losses to the insurance fund); the lists were another means through which regulators monitored and addressed problems or potential problems at the 18 institutions prior to declines in PCA capital categories.

[36]Federal Deposit Insurance Corporation Office of the Inspector General, *The Role of Prompt Corrective Action as Part of the Enforcement Process*, Audit Report No. 03-038 (Washington, D.C.: Sept. 12, 2003).

[37]Institutions with CAMELS composite ratings of 4 or 5 are placed on the problem institutions list. When FDIC's Division of Resolution and Receivership becomes involved in the resolution of any institution, it places that institution on the resolution cases list. Institutions that are deemed likely to fail within 1 year are placed on the projected failure list. FDIC is responsible for maintaining each of the lists. Regulators also may maintain their own watch lists; however, we did not determine whether any of the institutions in our sample appeared on any of these lists.

Figure 6: Institutions on Regulator Watch Lists

	FDIC problem institutions list	FDIC resolution cases list	FDIC projected failure list
Pulaski Savings Bank	●	●	●
Rock Hill Bank and Trust	●	●	●
CIB Bank	●	●	●
Southern Pacific Bank	●	●	●
Deuel County State Bank	●	●	●
New Century Bank	●	●	●
Federal Reserve Open Bank 1	●	●	●
Federal Reserve Open Bank 2	●	●	●
First National Bank (Lubbock)	●	●	●
Georgia Community Bank	●	●	●
OTS Open Thrift 1	●	●	●
Compubank	●	●	
Bank of Greenville	●		●
FDIC Open Bank 1	●		●
FDIC Open Bank 2	●		
Harbor Bank	●		
First Heights Bank	●		

Source: GAO analysis of regulatory data.

Consistent with banks and thrifts exhibiting declining CAMELS ratings and appearing on one or more watch lists prior to or concurrent with becoming undercapitalized, at least 15 of the 18 banks and thrifts that we reviewed had informal or formal enforcement actions in place prior to becoming undercapitalized.[38] Although we did not examine the effectiveness of these prior actions in addressing deficiencies, the following examples illustrate the types and numbers of enforcement actions regulators took at some of the institutions in our sample.[39]

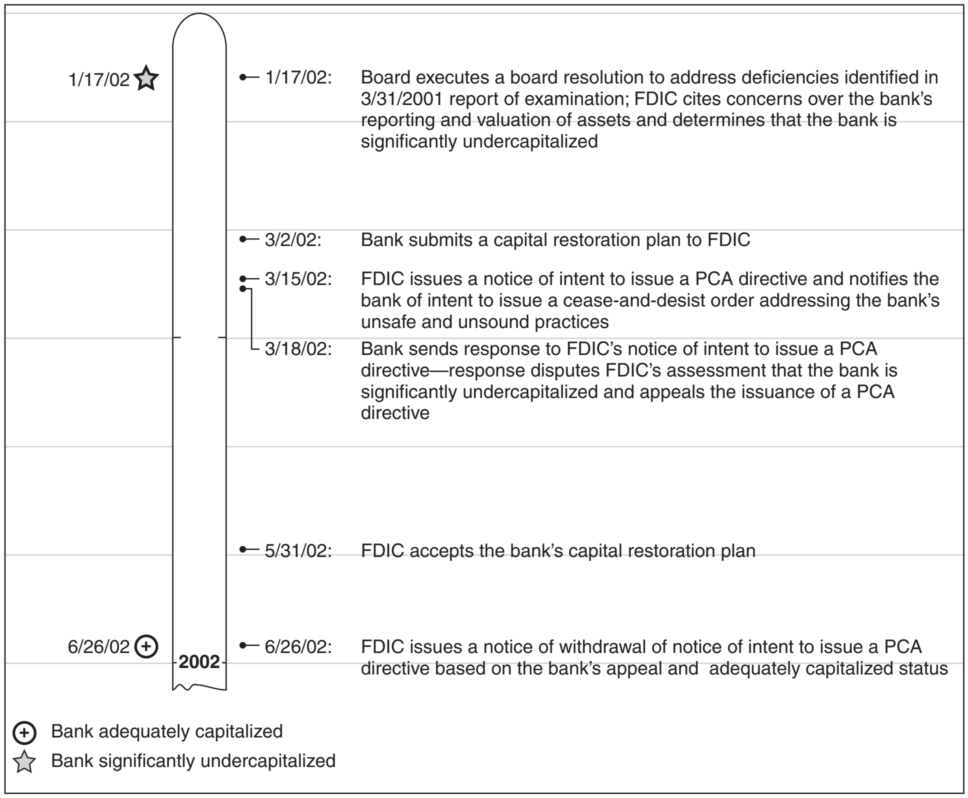
Although FDIC Open Bank 1 and FDIC examiners disagreed over the bank's capital status, FDIC required the bank's board of directors to execute a board resolution to address certain safety and soundness deficiencies identified as part of an examination (see fig. 7). When the

[38]Because we only examined enforcement-related documents for the four quarters prior to when these institutions became undercapitalized or worse by PCA standards, the number of institutions with prior enforcement action actually may be greater than 15.

[39]The enforcement actions detailed in the following examples may not represent all the enforcement actions regulators took against these institutions because we only reviewed documents for the four quarters prior to the institutions becoming undercapitalized or worse.

bank failed to adequately address the identified deficiencies, FDIC issued a cease-and-desist order.

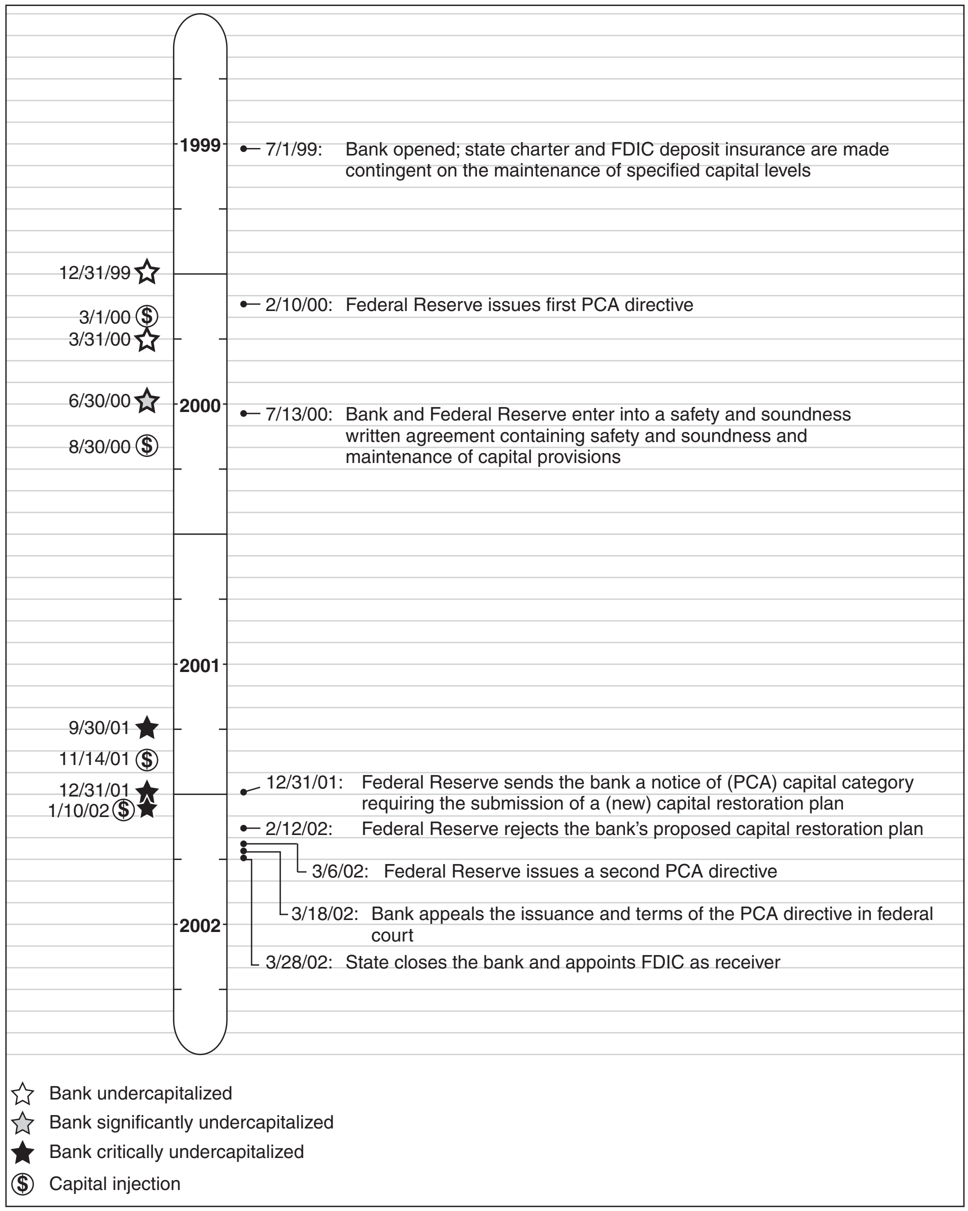
Figure 7: Timeline of Enforcement Actions, FDIC Open Bank 1



Source: GAO analysis of regulatory data.

When New Century Bank opened in July 1999, the Federal Reserve, the state regulator, and FDIC all required the bank to maintain capital in excess of the PCA well-capitalized minimums to obtain a state charter and FDIC insurance (see fig. 8). Throughout its existence, the bank not only failed to maintain these capital levels, but also failed to remain adequately capitalized by PCA standards. The Federal Reserve attempted to address these capital and other safety and soundness deficiencies through PCA directives and other formal enforcement orders. When the bank proved incapable of maintaining minimum capital levels, the state regulator closed it and appointed FDIC as receiver.

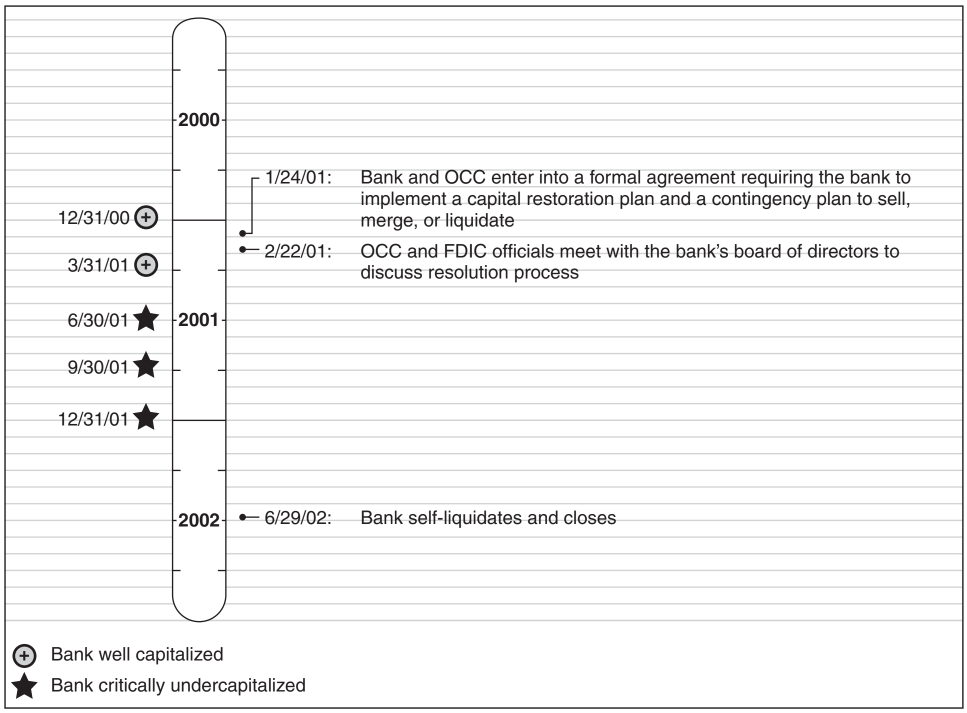
Figure 8: Timeline of Enforcement Actions, New Century Bank



Source: GAO analysis of regulatory data.

OCC examiners identified Compubank as posing serious safety and soundness concerns related to earnings when the bank was well capitalized by PCA standards (see fig. 9). The bank had high operating losses because of high overhead expenses caused by expanding operations in anticipation of high growth. As a result, OCC required the bank to enter into a written agreement, which stipulated that the bank implement a capital restoration plan and develop a contingency plan to sell, merge, or liquidate. Five months later, the bank reported that it was critically undercapitalized by PCA standards. The bank began the self-liquidation process and closed in June 2002.

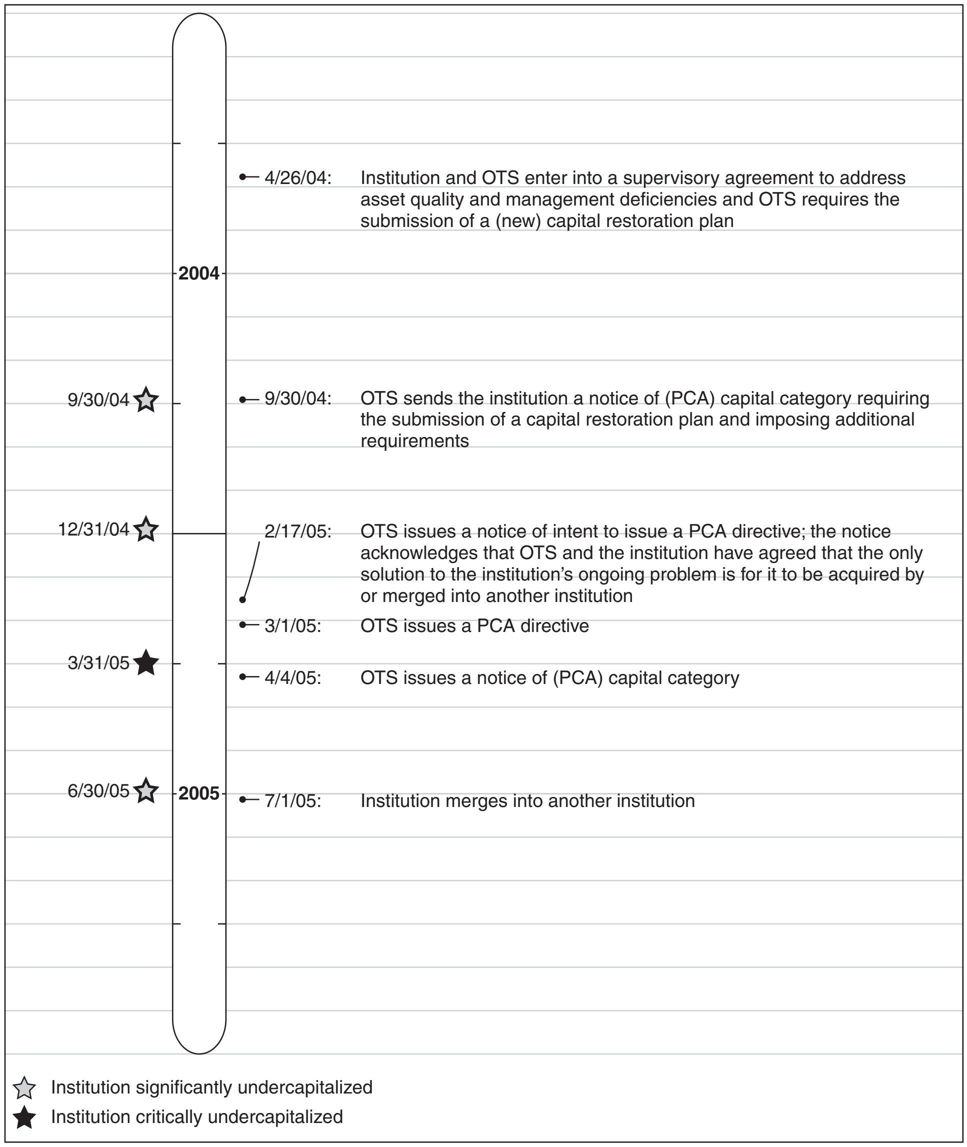
Figure 9: Timeline of Enforcement Actions, Compubank



Source: GAO analysis of regulatory data.

Approximately 5 months before Georgia Community Bank became undercapitalized, OTS and the institution entered into a supervisory agreement in response to regulator concerns about the institution's asset quality and management (see fig. 10). When the institution reported it was significantly undercapitalized, OTS issued a PCA directive; however, the institution was unable to recapitalize and as a result, it merged into another institution in July 2005.

Figure 10: Timeline of Enforcement Actions, Georgia Community Bank



Source: GAO analysis of regulatory data.

Most Material Loss Reviews Also Found Appropriate Use of PCA, but Some Reviews Found Regulators Could Have Used PCA Sooner

We also reviewed material loss reviews of all institutions that failed with material losses to the insurance fund—losses that exceed $25 million or 2 percent of an institution's assets, whichever is greater—from 1992 through 2005 and in which regulators used PCA to address capital problems (see table 5).[40] In 12 of these 14 cases, the relevant IG found that PCA was applied appropriately—meaning that when institutions failed to meet minimum capital requirements, regulators required that they submit capital restoration plans and adhere to restrictions and requirements in PCA directives or other enforcement orders.

Table 5: Institutions with Material Losses and PCA to Address Capital Adequacy, 1992-2005

Institution	Regulator	Year of failure	Appropriate use of PCA
Bank of Harford	FDIC	1994	Yes
The Bank of San Pedro	FDIC	1994	Yes
Bank of Newport	FDIC	1994	Yes
First Trust Bank	FDIC	1995	Yes
Pacific Heritage Bank	FDIC	1995	Yes
BestBank	FDIC	1998	Yes
Pacific Thrift and Loan Company	FDIC	1999	Yes
Connecticut Bank of Commerce	FDIC	2002	Yes
Pioneer Bank	FRB	1994	Yes
Mechanics National Bank	OCC	1995	Yes
First National Bank of Keystone	OCC	1999	No
Hamilton Bank	OCC	2002	Yes
NextBank	OCC	2002	Yes
Superior Bank	OTS	2001	No

Source: GAO analysis of regulatory data.

Regulators appropriate use of PCA in institutions that failed with material losses are demonstrated by the following examples:

[40] Since 1992, 19 banks and thrifts failed with material losses. We excluded 4 of these institutions from our review because they either did not suffer from capital deficiencies that required the use of PCA or because their capital deficiencies predated the implementation of FDICIA. In one case (Southern Pacific Bank), the bank was selected as part of our sample of 24 institutions.

- According to the FDIC IG's material loss review on Connecticut Bank of Commerce, FDIC used enforcement actions other than PCA directives to address the bank's capital and other problems. Connecticut Bank of Commerce experienced capital deficiencies from 1991 through 1996 as a result of its poor asset quality. The bank operated under several cease-and-desist orders (1991, 1993, and 2001) and a memorandum of understanding, each of which contained requirements that the bank hold capital in excess of the required PCA minimums. Upon the detection of fraud in April 2002, the bank's capital was immediately exhausted and it became critically undercapitalized. On June 25, 2002, FDIC issued a PCA directive ordering the dismissal of the bank's chairman and president. On June 26, 2002, the Banking Commissioner for the State of Connecticut declared Connecticut Bank of Commerce insolvent, ordered it closed, and appointed FDIC as receiver.

- Prior to the implementation of legislation implementing PCA, Federal Reserve examiners attempted to restore Pioneer Bank to a safe and sound operating condition through written agreements entered into in 1986 and 1991. Despite these enforcement actions, the bank's condition continued to deteriorate and in June 1994, the Federal Reserve issued a PCA directive requiring Pioneer Bank to become adequately capitalized though the sale of stock or to be acquired by or merge into another institution. When the bank was unable to comply with the terms of the PCA directive, the California State Banking Department issued a capital impairment order on July 6, 1994, and closed the bank on July 8, 1994. In its material loss review of Pioneer Bank, the Federal Reserve IG concluded that the level of supervisory actions taken by the Federal Reserve was within the range of acceptable actions for the problems the bank experienced.

- In October 2001, NextBank's capital level dropped from well capitalized to significantly undercapitalized based on findings from an examination conducted by OCC's Special Supervision and Fraud Division. The Department of the Treasury (Treasury) IG noted in its material loss review that the bank was at that point automatically subject to restrictions under PCA. In November 2001, OCC issued a PCA directive requiring the bank, among other things, to develop a capital restoration plan; file amended Call Reports; restrict new credit card account originations to prime lenders; and restrict asset growth, management fees, and brokered deposits. By December 2001, NextBank advised OCC that it would not be able to address its capital deficiency. In January 2002, NextBank and its parent company took steps to liquidate the bank. OCC appointed FDIC as receiver on February 7, 2002. While the Treasury IG did not find fault with OCC's use of PCA to address NextBank's capital deficiencies, it found that PCA's effectiveness in NextBank's situation was difficult to assess given the short amount of time that passed between when the bank's capital declined below PCA minimum requirements and when the bank failed.

In two cases, the relevant IG determined that the regulator's use of PCA was not appropriate—First National Bank of Keystone (Keystone) and Superior Bank, regulated by OCC and OTS, respectively. In both cases, the Treasury IG found that the regulator failed to identify the institution's true financial condition in a timely manner and thus could not apply PCA's capital-based restrictions because the institution's reported capital levels met or exceeded the minimum required levels. Because PCA was not implemented timely in these cases, it was not effective in containing losses to the deposit insurance fund.[41]

- According to the Treasury IG, Keystone's operating strategy entailed growth into the high-risk areas of subprime lending and selling loans for securitization.[42] The bank's growth in these areas occurred without adequate management systems and controls, and inaccurate financial records masked the bank's true financial condition. At the time of the bank's failure, allegations of fraud were under investigation. In its material loss review of the bank, the IG noted that if OCC had reclassified the bank's capital category from well capitalized to adequately capitalized following an examination in late 1997, OCC could have restricted the bank's use of brokered deposits and applied certain interest-rate restrictions in an effort to curb the bank's growth 6 months before its capital levels showed serious signs of decline. Instead, these restrictions were not put in place until June 1998 when OCC required the bank to adjust its reported capital based on examination findings—this adjustment resulted in a downgrade in the bank's capital category from well capitalized to undercapitalized and trigged PCA restrictions. Despite this finding, the IG noted that it was unclear whether reclassification would have actually had its desired effect—after the restrictions were trigged in June 1998, the bank continued to intentionally violate them.

[41]The FDIC IG made similar findings in its report on the effectiveness of PCA in preventing losses to the deposit insurance fund. See Federal Deposit Insurance Corporation Office of the Inspector General, *The Effectiveness of Prompt Corrective Action Provisions in Preventing or Reducing Losses to the Deposit Insurance Funds*, Audit Report No. 02-013 (Washington, D.C.: Mar. 26, 2002).

[42]Typically, subprime loans are for persons with poor or limited credit histories and carry a higher rate of interest than prime loans to compensate for increased credit risk. Securitization is the process of selling to investors (public or private) asset-backed securities that represent an interest in the cash flow generated by the loans.

- The Treasury IG's material loss report on Superior Bank notes that while the immediate causes of the bank's insolvency in 2001 appeared to be improper accounting and inflated valuations of residual assets, the causes could be attributed to a confluence of factors going back as early as 1993, including asset concentration, rapid growth into a new high-risk activity, deficient risk management systems, liberal underwriting of subprime loans, unreliable loan loss provisioning, economic factors affecting asset valuation, and lack of management response to supervisory concerns.[43] Our 2002 testimony on the failure of Superior Bank and the IG's material loss review suggested that had OTS acknowledged problems at Superior Bank when examiners became aware of them in 1993, PCA would have been triggered sooner and might have slowed the bank's growth and contained its losses to the deposit insurance fund.[44] The IG further noted that OTS's delayed detection of so many critical problems suggests that the advantage of PCA as an early intervention tool depends as much on timely supervisory detection of actual, if not developing, problems as it does on capital.

Regulators Have Made Limited and Targeted Use of the Noncapital Supervisory Actions Available under Sections 38 and 39

Under section 38 regulators have the ability to reclassify an institution's capital category and dismiss officers and directors from deteriorating banks and thrifts. However, regulators have made limited use of these authorities, preferring instead to use moral suasion (as part of or separate from the examination process) or other enforcement actions to address deficiencies. Under section 39, regulators can require institutions to implement plans to address deficiencies in their compliance with regulatory safety and soundness standards. Regulators have used section 39 with varying frequency to address noncapital deficiencies; however, those that use the provision use it to address targeted deficiencies, such as noncompliance with certain laws or requirements, and when an institution's management generally is willing and able to comply with required corrective actions.

[43]Residual assets are assets remaining after sufficient assets are dedicated to meet all senior debtholders' claims in full.

[44]GAO, *Bank Regulation: Analysis of the Failure of Superior Bank, FSB, Hinsdale, Illinois*, GAO-02-419T (Washington, D.C.: Feb. 7, 2002).

Regulators Prefer to Use Other Informal and Formal Enforcement Powers over PCA's Reclassification and Dismissal Authorities

In addition to their authority under PCA to reclassify an institution's PCA capital category or require improvements in management at significantly undercapitalized institutions, regulators also can use other means—such as moral suasion or more formal enforcement actions—to address deficiencies or effect change at an institution. Under section 38(g), regulators have the authority to reclassify or downgrade an institution's PCA capital category to apply PCA restrictions and requirements in advance of a decline (or further decline) in capital if the regulator determines that the institution is operating in an unsafe or unsound manner or engaging in an unsafe or unsound practice.[45] Regulators also may treat an undercapitalized institution as if it were significantly undercapitalized if they determine that doing so is "necessary to carry out the purpose" of PCA. In practice, this means that regulators may, in certain circumstances, treat a well-capitalized institution as if it were adequately capitalized, an adequately capitalized institution as if it were undercapitalized, and an undercapitalized institution as if it were significantly undercapitalized. Regulators are prohibited from reclassifying or downgrading an institution more than one capital category and cannot downgrade a significantly undercapitalized institution to critically undercapitalized. Regulators also may require improvements in the management of a significantly undercapitalized institution—for example, through the dismissal of officers and directors. This provision can be used alone or in conjunction with the reclassification provision. In the latter case, a regulator can require the dismissal of officers and directors from an undercapitalized institution.

All four regulators said that they generally prefer other means of addressing problems to PCA. According to the regulators, the authority to reclassify an institution's capital category is of limited use on its own because regulators' ability to address both noncapital (such as management) and capital deficiencies through other informal and formal enforcement actions prior to a decline in capital effectively negates the need to reclassify an institution to apply operating restrictions or requirements. Regulators' use of section 38's reclassification authority is consistent with their views on it—since 1992, FDIC, the Federal Reserve,

[45]FDIA does not define unsafe and unsound practice or condition—such determinations are to be made by the appropriate regulator based on the facts and circumstances of each case. For purposes of the cease-and-desist authority under section 8(b)(8) of FDIA, an institution with a less-than-satisfactory rating (CAMELS 3, 4, or 5) for asset quality, management, earnings, or liquidity may be deemed by the appropriate federal regulator to be engaging in an unsafe and unsound practice.

and OTS have never reclassified an institution's capital category. OCC has used the authority twice.

All four regulators said that section 38's dismissal authority under section 38(f)(2)(F) is valuable as a deterrent and a potential tool, despite their infrequent use of it—FDIC has used the authority six times since 1992 and OCC once; the Federal Reserve and OTS have never used the authority. They said that the PCA authority occupies the middle ground between moral suasion and the removal and prohibition authority under section 8(e) of FDIA. According to the regulators, the first step in confronting problem officers and directors is moral suasion—that is, reminding the board of directors that it has an obligation to ensure that the institution is competently managed. In many cases, we were told that this reminder often is enough to force the resignations of problem individuals.[46] Dismissal under section 38 represents a "middle of the road" option—it results in a ban from serving as an officer or director in the institution in question. In order to be reinstated, the dismissed individual must demonstrate that he or she has the capacity to materially strengthen the institution's ability to become adequately capitalized or correct unsafe or unsound conditions or practices. Regulators also have a more severe option—removal under section 8(e), which results in an industrywide prohibition and consequently, requires proof of a high degree of misconduct or malfeasance.[47] Data show that regulators have used section 8(e) with some regularity (see fig. 11). The regulators said that if an individual's misconduct rises to the level required to support removal and

[46]Data were not available on the frequency with which regulators were able to informally persuade individuals to resign from institutions.

[47]Under section 8(e) of FDIA, regulators must make three determinations to institute an action for removal or prohibition: misconduct, the effect of the misconduct, and the individual's culpability for the misconduct. Misconduct includes (1) violation of any law, regulation, or final section 8(b) order; (2) violation of any condition imposed in writing by the appropriate federal agency in connection with the grant of any application or other request by the institution; (3) violation of any written agreement between the institution and the appropriate federal agency; (4) engagement or participation in any unsafe or unsound practice; or (5) engagement in any act, omission, or practice that constitutes a breach of fiduciary duty. The regulator then must demonstrate that as a result of the individual's misconduct any of the following occurred: (1) the institution suffered or probably will suffer financial loss or other damage, (2) the interests of the institution's depositors have been or could be prejudiced, or (3) the individual in question received financial gain or other benefit as a result of his or her conduct. To assess culpability, regulators must determine whether the individual's conduct involved personal dishonesty or demonstrated a willful or continuing disregard for the safety and soundness of the institution.

prohibition under section 8(e), use of that authority generally is preferable to dismissal under section 38.

Figure 11: Regulators Use of Section 8(e), 1992-2005

	FDIC	OTS	OCC	Federal Reserve
1992	50	92	38	8
1993	74	81	38	1
1994	56	96	47	7
1995	54	55	14	5
1996	71	42	30	6
1997	48	48	42	2
1998	22	11	16	4
1999	33	4	33	2
2000	24	27	36	4
2001	14	14	25	0
2002	19	9	28	1
2003	35	8	43	1
2004	62	20	38	1
2005	79	19	35	6
Total	**641**	**526**	**463**	**48**

Source: GAO analysis of regulatory data.

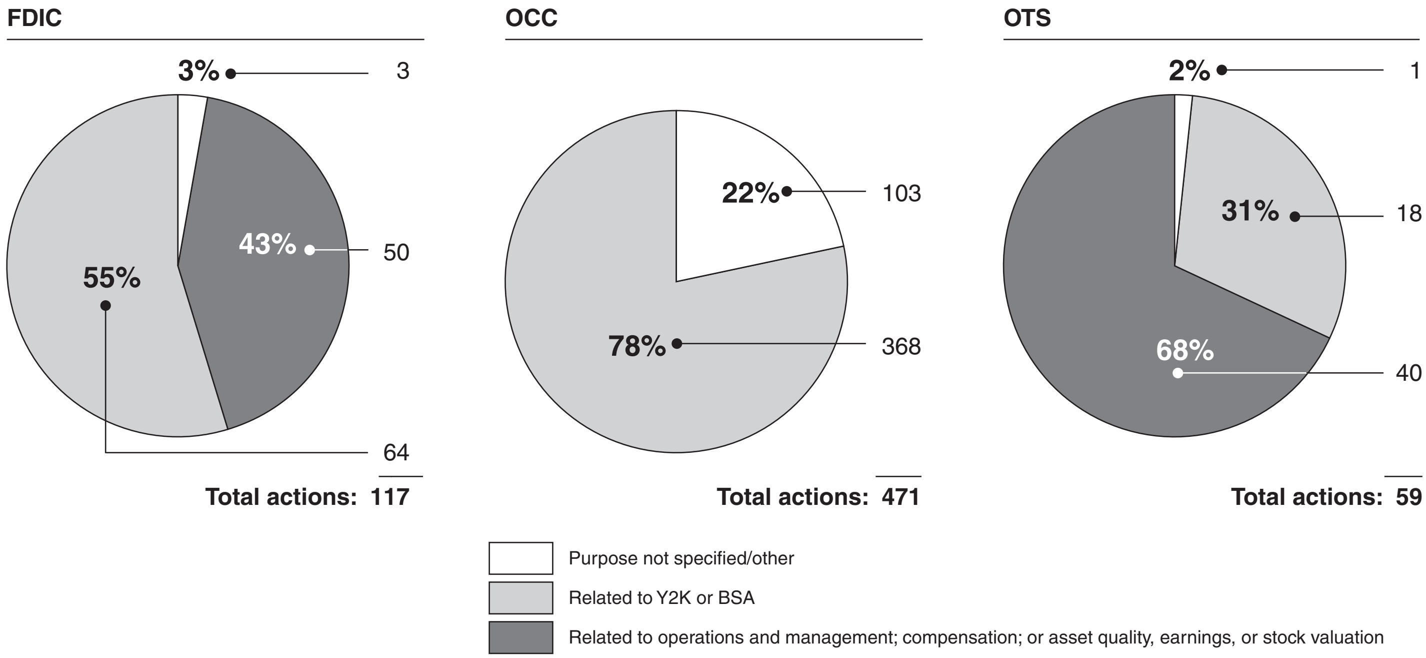
The regulators also noted that moral suasion and section 8(e) are not necessarily capital based, meaning that both can be used at times when PCA cannot. The regulators acknowledged that section 38 permits them to reclassify an institution's capital category to dismiss an officer or director; however, they said that because section 38 only allows them to dismiss individuals from institutions that are undercapitalized or worse by PCA standards, the tool generally is not available to them in these good economic times when all or most of the institutions they regulate are well capitalized. OCC was of the view that section 38's dismissal authority could be more useful if it were uncoupled from capital and instead triggered by less-than-satisfactory ratings in the management component of the CAMELS rating. In particular, OCC officials said that linking the authority to the CAMELS rating could provide regulators with the authority to dismiss individuals who did not meet the criteria for removal and prohibition under section 8(e) and from institutions with boards that were unresponsive to regulators' moral suasion.

Regulators Use Section 39 to Address Targeted Safety and Soundness Deficiencies

Changes to section 39 in 1994 gave regulators considerable flexibility over how and when to use their authority under the section to address safety and soundness deficiencies at the institutions they regulate.[48] Like section 38's dismissal authority, section 39 represents a "middle of the road" option between informal enforcement actions (such as a commitment letter) and formal enforcement actions (such as a cease-and-desist order). In varying degrees, they have used section 39 to address deficiencies in the three broad categories defined under the section: operations and management; compensation; and asset quality, earnings, and stock valuation (see fig. 12). Finally, regulators said that they prefer to use section 39 when regulators are certain that management is willing and able to address identified deficiencies, even if management has not been responsive to informal regulatory criticisms in the past. For example, FDIC, OCC, and OTS have all used section 39 to require institutions to achieve compliance with Year 2000 (Y2K) or Bank Secrecy Act (BSA) requirements (both of which relate to institutions' operations).

[48]The Federal Reserve has established safety and soundness standards under section 39, but has not used the enforcement mechanisms under the section to address deficiencies in favor of using other supervisory authorities. The following discussion about regulators use of section 39 is therefore limited to FDIC, OCC, and OTS.

Figure 12: Regulators Use of Section 39, 1995-2005



Source: GAO analysis of regulatory data.

Officials from the Federal Reserve told us that they use memorandums of understanding in the same way that the other three regulators use section 39—that is, to address targeted deficiencies at institutions that are willing and able to make required changes.

According to the regulators, formal enforcement actions, such as section 8(b) cease-and-desist orders or written agreements, are better reserved for institutions that have multiple or complex problems and in cases where management is unable to define what steps must be taken to address problems independent of the regulator or is unwilling to take action. Since 1995 (the year regulators issued the section 39 guidelines), regulators have made frequent use of section 8(b) of FDIA to address problems associated with operations and management; compensation; and asset quality, earnings, and stock valuation. From 1995 through 2005, FDIC and the Federal Reserve issued 288 and 98 cease-and-desist orders or written agreements, respectively, to address deficiencies in these three areas. OTS issued 47 cease-and-desist orders related to deficiencies in operations.[49]

FDIC Has More Tightly Linked Deposit Insurance Premiums to Institutional Risk, but Some Expressed Concerns about Certain Aspects of the New System

Under authority provided by the Federal Deposit Insurance Reform Act of 2005, FDIC now prices its deposit insurance more closely to the risk FDIC officials judge an individual bank or thrift presents to the insurance fund. To do this, FDIC has created a system in which it evaluates a number of financial and regulatory factors specific to an individual bank or thrift. This replaces a system that was also risk based, but which differentiated risk less finely. Industry officials and academics to whom we spoke and selected organizations that submitted comment letters to FDIC generally supported the concept of the new system. However, several voiced concern about what they saw as the new system's subjectivity and complexity and questioned whether the new system might produce unintended consequences, including upsetting relations between bankers and their regulators.

Changes to FDIC's Deposit Insurance System More Closely Tie Premiums to the Risk Institutions Present to the Deposit Insurance Fund, but Stop Short of Completely Risk-Based Pricing

FDIC's recent changes to the deposit insurance system more closely tie an individual bank or thrift's deposit insurance premium to the risk it presents to the insurance fund. In general, FDIC does this by considering three sets of factors—supervisory (CAMELS) ratings and financial ratios or credit agency ratings—while also distinguishing between large institutions with credit agency ratings and all other institutions. However, the system stops short of completely risk-based pricing.

Old System Relied on Two Factors to Determine Risk and Premiums

FDIC's previous method for determining premiums relied on two factors—capital levels and supervisory ratings—to determine institutions' risk and premiums.[50] FDIC established three capital groups—termed 1, 2, and 3 for well-capitalized, adequately capitalized, and undercapitalized institutions,

[49]OCC was unable to segregate orders covering operations and management; compensation; and asset quality, earnings, and stock valuation from all cease-and-desist orders issued over the period. According to data obtained from OCC's Web site, the regulator issued 240 cease-and-desist orders from 1995 through 2005.

[50]See *Assessments*, 71 Fed. Reg. 69282, 69283-84 (2006).

respectively—based on leverage ratios and risk-based capital ratios.[51] Three supervisory groups—termed A, B, and C—reflected, respectively, financially sound institutions with only a few minor weaknesses; institutions with weaknesses, which if not corrected could result in significant deterioration and increased risk of loss to the insurance fund; and institutions that pose a substantial probability of loss to the insurance fund unless effective corrective action is taken. Based on its capital levels and supervisory ratings, an institution fell into one of nine risk categories (see table 6). However, the vast majority of institutions—95 percent at year-end 2005—fell into category 1A, even though, according to FDIC officials, there were significant differences among individual institutions' risk profiles within the category.

Table 6: Distribution of Institutions among Risk Categories in FDIC's Previous Deposit Insurance System, as of December 31, 2005

	Supervisory category		
Capital group	**A**	**B**	**C**
1: Well capitalized	1A	1B	1C
	(8,358)	(373)	(50)
2: Adequately capitalized	2A	2B	2C
	(54)	(7)	(1)
3: Undercapitalized	3A	3B	3C
	(0)	(0)	(2)

Source: FDIC.

Further, according to FDIC, in 2005, 95 percent of institutions did not pay premiums into the insurance fund because the agency was barred from charging premiums to well-managed and well-capitalized institutions when the deposit insurance fund was at or above its designated reserve ratio, and was expected to remain there.[52] Because nearly all institutions paid

[51]These capital categories are different from the PCA capital categories discussed elsewhere in this report. Where PCA divides institutions into five capital categories, the previous insurance system used three.

[52]Deposit Insurance Funds Act of 1996, title II, subtitle G of Pub. L. No. 104-208, § 2708(c), 110 Stat. 3009, 3009-497 (1996) (codified at 12 U.S.C. § 1817(b)(2)(A)(v)). The repeal of section 1817(b)(2)(A)(v) was effective on January 1, 2007, the date that FDIC's final regulations under Section 2109(a)(5) of the Federal Deposit Insurance Reform Act of 2005 took effect. See Federal Deposit Insurance Reform Act of 2005, supra note 1, § 2104(e). The designated reserve ratio is the insurance fund's reserve level, expressed as a fraction of total estimated insured deposits.

the same rate under the old system, lower-risk institutions effectively subsidized higher-risk institutions.[53]

The New System Links Risk and Premiums More Closely

To tie institutions' insurance premiums more directly to the risk each presents to the insurance fund, FDIC created a system that generally (1) differentiates between large and small institutions, specifically between institutions with current credit agency ratings and $10 billion or more in assets and all other institutions; (2) for institutions without credit agency ratings, forecasts the likelihood of a decline in financial health (referred to throughout this report as the general method); (3) for institutions with credit agency ratings, uses those ratings, plus potentially other financial market information, to evaluate institutional risk (referred to throughout this report as the large-institution method); and (4) requires all institutions to pay premiums based on their individual risk.[54]

Premiums under the general method and the large-institution method are calculated differently, based on the availability of relevant information for institutions in each category. The general method uses two sources of information as inputs to a statistical model designed to predict the probability of a downgrade in an institution's CAMELS rating: (1) financial ratios (such as an institution's capital, past-due loans, and income) and (2) CAMELS ratings. According to FDIC officials, little other information is readily available to assess risk for these institutions. However, FDIC data show that the higher on the CAMELS scale institutions are rated, the higher the rate of failure—the 5-year failure rate is 0.39 percent for CAMELS 1-rated banks, 3.84 percent for 3-rated banks, and 46.92 percent for 5-rated banks—thus making CAMELS ratings and financial ratios a reasonable basis for assessing risk.[55]

The large-institution method also uses CAMELS ratings. But rather than employ financial ratios, it incorporates market-based information—credit agency ratings of an institution's debt offerings. FDIC officials told us that

[53]According to FDIC officials, although most institutions paid no premiums in recent years, lower-risk institutions implicitly subsidized the premiums of higher-risk institutions—even when the premium rate charged to most institutions was zero, the activities of higher-risk institutions raised the chances of insurance fund losses and thus higher premiums for all institutions.

[54]FDIC officials refer to the general method as the financial ratio method and the large-institution method as the debt rating method.

[55]These data are only for banks and do not include thrifts. Also excluded are failures in which fraud was determined to be a primary contributing factor.

incorporating debt ratings provides a fuller, market-based picture of an institution's condition than do financial ratios. For example, some large institutions concentrate in certain activities, such as transactions processing or credit cards, while others provide more general services. According to FDIC officials, financial ratios may not adequately distinguish among such different activities. Also, credit ratings determine how much institutions must pay to obtain funds in capital markets—well-rated banks and thrifts will pay less, while institutions the market judges as riskier will pay more. Thus, according to FDIC officials, it makes sense to align premiums with these market-based funding costs. In addition to its ability to use the CAMELS and credit ratings, FDIC also has the flexibility to adjust premiums for large institutions up to 0.5 basis points up or down based on other relevant information (such as market analyst reports, rating-agency watch lists, and rates paid on subordinated debt) as well as stress considerations (such as how an institution would be expected to react to a sudden and significant change in interest rates).[56] If a large institution does not have an available credit agency rating, its premium is calculated according to the general method.[57]

The new insurance system places banks and thrifts into one of four risk categories, each of which has a corresponding premium or range of premiums. These "base rate" premiums range from 2 to 4 basis points for banks and thrifts in the best-rated category, risk category I, to 40 basis points for institutions in the bottom category, risk category IV (see table 7).[58] Thus, for example, under the base rate schedule the riskiest institutions (risk category IV) pay a premium rate 20 times greater than the best-rated banks and thrifts (minimum rate, risk category I). Even within the best category, riskier institutions pay twice the rate paid by the safest banks and thrifts, reducing the tendency for subsidies under the old

[56]Subordinated debt is repayable only after other debts with higher claim priority have been satisfied.

[57]According to FDIC, approximately 10 to 15 percent of the 120 institutions with assets of at least $10 billion do not have available credit agency ratings. As with large institutions with credit agency ratings, FDIC may use other financial market information to evaluate these institutions' risk.

[58]With some minor adjustments, premiums are assessed on total domestic deposits.

system.[59] The same premium schedule applies to all institutions, regardless of their premium assessment method.

Table 7: Base Rate Premiums by Risk Category under FDIC's New Deposit Insurance System

	Risk category			
	I	II	III	IV
Annual base rate (premiums in basis points)	Minimum – 2 Maximum – 4	7	25	40

Source: FDIC.

Under the new system, FDIC has limited authority, without resorting to new rule making, to vary premiums from the base rates as necessary and appropriate. For assessments beginning in 2007, FDIC has used this flexibility to increase premiums by 3 basis points over the base rates. Thus, the current rate for risk category I is 5 to 7 basis points, rather than 2 to 4 basis points; for risk category II, the premium is 10 basis points; for risk category III, the premium is 28 basis points; and for risk category IV, the premium is 43 basis points. According to FDIC, the increase in premiums for 2007 was necessary because of strong growth in insured deposits and the availability of premium credits to many institutions under the terms of the Federal Deposit Insurance Reform Act of 2005.

In general, to set the premium rates for each of the four risk categories, FDIC officials told us they considered both what the differences should be in premiums among risk categories and, taking those differences into account, the level at which the premiums should be established. Considering the two together, the goal was to create a schedule of rates with the best chance of maintaining the insurance fund with a designated reserve ratio from 1.15 percent to 1.35 percent of insured deposits, with

[59]Section 2107(a) of the Federal Deposit Insurance Reform Act of 2005 amended section 7(e)(3) of FDIA (codified at 12 U.S.C. § 1817(e)(3)) to require that FDIC's Board provide by regulation a onetime premium credit to eligible banks and thrifts to offset future premiums based on certain previous payments into the deposit insurance fund. The aggregate amount of funds available for such onetime credits is capped at the amount FDIC could have collected if it had imposed an assessment of 10.5 basis points on the combined assessment base of the Bank Insurance Fund and the Savings Association Insurance Fund as of December 31, 2001. FDIC has calculated this amount to be approximately $4.7 billion. See *One-Time Assessment Credit*, 71 Fed. Reg. 61374, 61375 (2006) (final rule). While their credits are drawn down, some institutions will pay lower premiums; however, when the credits are exhausted, all institutions will be assessed full premiums.

the former representing the required minimum under the Federal Deposit Insurance Reform Act of 2005, and the latter being the level at which mandated rebates of premiums to banks and thrifts must begin.[60] FDIC officials told us they established the level of premiums based on four factors: (1) historical data on insurance losses, (2) FDIC operating expenses, (3) projected interest rates and their effect on FDIC investment portfolio income, and (4) expected growth of insured deposits.[61]

While Focusing More on Risk, the New System Stops Short of Completely Risk-Based Pricing

Although the new system ties premiums more specifically to the risk an individual institution presents to the insurance fund, it does not represent completely risk-based pricing. As a result, some degree of cross-subsidy still exists in the new system. In particular, as estimated by FDIC, institutions in risk category IV would need to pay premiums of about 100 basis points to cover the expected losses of the group. However, FDIC has chosen to set the base rate premium for these banks and thrifts at 40 basis points, or 60 percent below the indicated premium. In doing so, FDIC officials told us they sought to address long-standing concerns of the industry, regulators, and others that premiums should not be set so high as to prevent an institution that is troubled and seeking to rebuild its health from doing so. In contrast, some have suggested that capping premiums to address such concerns ultimately may cost the insurance fund more in the long run—lower premiums for riskier institutions may allow them to remain open longer, resulting in greater losses if and when they eventually fail. FDIC officials said that the number of institutions in category IV is small and thus the trade-off between lower premiums for troubled institutions and potentially larger losses later is not significant. Further, they said that the 40 basis point base rate applicable to the highest risk institutions represents a sizable increase over the assessment rate for these institutions under the previous system.

[60]Federal Deposit Insurance Reform Act of 2005, §§ 2105 and 2107, 120 Stat. 14 and 16 (2006). Section 2105 of the act amended section 7(b)(3) of FDIA to require FDIC to establish by regulation the insurance fund's reserve level, known as the designated reserve ratio, within a range of 1.15 to 1.50 percent of insured deposits. If the reserve ratio exceeds 1.35 percent, but is not more than 1.50 percent, FDIC generally must rebate to institutions half of any amount above 1.35 percent. If the reserve ratio exceeds 1.50 percent, FDIC must rebate all amounts in the fund above the 1.50 percent level.

[61]FDIC omitted from design of its new system data on institutions insured by the former Federal Savings and Loan Insurance Corporation. FDIC officials told us they did so because the information was unavailable or deemed unreliable or unrepresentative.

Another way FDIC's new premium pricing system stops short of being completely risk based is that it does not take into account "systemic risk." In a fully risk-based system, premiums would be set to reflect two major components: expected losses plus a premium for systemwide risk of failure or default. According to academics we spoke to, FDIC's new system reflects the first component, but not the second. Incorporating the notion of systemic risk into the premium calculation would acknowledge that failure of some banks could have repercussions to the financial system as a whole and that such failures are more likely during economic downturns. FDIC officials told us that the new system does not reflect systemic risk for several reasons. First, there is an alternative mechanism for capturing what is effectively a systemic risk premium.[62] Second, FDIC officials said that charging an up-front premium for systemic risk could prevent institutions from getting the best premium rate on the basis of their size, which is not permitted under the 2005 Federal Deposit Insurance Reform Act.[63] And finally, FDIC officials said that FDIC has other sources of financing available to address losses resulting from large-scale failures, including borrowing from the industry, a $30 billion line of credit with Treasury, and the ability to borrow from the Federal Financing Bank and the Federal Home Loan Bank system.

[62]Section 13 of FDIA (codified at 12 U.S.C. § 1823) authorizes FDIC to undertake various actions or provide assistance to a failing institution. FDIC is obligated to pursue a course of resolution that is the least costly to the insurance fund, except in cases involving systemic risk. 12 U.S.C. § 1823(c)(4). Under the "systemic risk" exception, if upon recommendation of FDIC's Board of Directors and the Board of Governors of the Federal Reserve System (in each case by a two-thirds vote of the members of the boards), the Secretary of the Treasury, in consultation with the President, determines that pursuing the least costly alternative would have serious adverse effects on economic conditions or financial stability, then FDIC may take any action or provide any assistance authorized under section 13 that would avoid or mitigate such adverse effects. In such cases, the loss to the insurance fund arising from such action or assistance is recaptured by special assessment on all insured institutions. This assessment effectively amounts to a systemic risk premium. Because the assessment is not levied on insured deposits, but rather on nonsubordinated liabilities, the effect is to shift the burden to larger institutions—the institutions that pose the greatest systemic risks.

[63]Section 2104(a)(2) of the Federal Deposit Insurance Reform Act (codified at 12 U.S.C. § 1817(b)(2)(D)) specifically prohibits barring an institution from obtaining the lowest premium solely because of size. Pub. L. No. 109-171, 120 Stat. 12. Large institutions generally pose the greatest systemic risk, so according to FDIC officials, charging a systemic risk premium could effectively amount to a surcharge based on size, improperly disqualifying them from the lowest rate.

Industry Officials and Academics Generally Support the New System, but Have Voiced Concerns about Certain Aspects

In our review of selected comments to FDIC's proposed rule and interviews with bankers, industry trade groups, and academics, we found that the industry generally supported the concept of a more risk-based insurance premium system.[64] However, several of those to whom we spoke and many organizations that submitted comments to FDIC raised several concerns about the new system. First, many said that the new system places too much weight on subjective factors, which could result in incorrect assessments of institutions' actual risk. Specifically, officials from two trade associations and one small bank who we interviewed questioned the inclusion of, or the weight given to, the management component of the CAMELS ratings.[65] One considered this component to be the most subjective of the CAMELS component areas. Six additional organizations noted in comment letters their concern with FDIC's plan to assign different weights to the CAMELS components, noting in at least one case that FDIC had provided no evidence to support using a weighted rating in place of the composite rating. FDIC officials said that the weights were set in consultation with the other federal banking regulators and represent the relative importance of each component as it pertains to the risk an institution presents to the insurance fund. Specifically, FDIC officials said that asset quality, management, and capital are often key factors in an institution's failure and any subsequent losses to the insurance fund, and thus warrant more consideration than other factors in the calculation of risk.

Similarly, in comment letters to FDIC, five large banks, three trade groups, and one financial services company expressed concern with the part of the rule that gives FDIC flexibility to adjust large institutions' premiums up or down based on other information, including other market information and

[64]A majority of comments submitted to FDIC in response to its initial proposal for the new insurance system addressed two issues: (1) the automatic assessment of de novo institutions at the ceiling rate (4 basis points under the base rate schedule) in Risk Category I and (2) the possible treatment of Federal Home Loan Bank advances as volatile liabilities. FDIC's final rule relaxed treatment of de novo institutions and dropped volatile liabilities as a factor in the determination of premiums. Thirty-two organizations and individuals, including 6 we interviewed, provided comments to FDIC on issues and concerns with other aspects of FDIC's deposit insurance system. The comments of these institutions are reflected in our discussion.

[65]According to FDIC, CAMELS ratings capture information on an institution's risk management practices that is not otherwise reflected in premium calculations. Under the new system, FDIC generally will consider an institution's ratings in each of the CAMELS components in determining risk. Each component will receive the following weight: C, 25 percent; A, 20 percent; M, 25 percent; and E, L, and S, 10 percent each.

financial performance and conditions measures (such as market analyst reports, assessments of the severity of potential losses, and stress factors). All of these organizations cautioned that to do so would undermine the assessments of institutions' primary regulators regarding their performance and health (as expressed in CAMELS ratings, a primary component of FDIC's system). According to FDIC, this authority to adjust ratings in consultation with other federal regulators is necessary to ensure consistency, fairness, and the consideration of all available information. FDIC officials said that the agency plans to clarify its processes for making any adjustments to ensure transparency and plans to propose and seek comments on additional guidelines for evaluating whether premium adjustments are warranted and the size of the adjustments.

Related to these concerns, officials from one large bank, one small bank, and one trade association and one of the academics with whom we spoke said that FDIC's new system is overly complicated and that it might not be readily apparent to bank or thrift management how activities at their respective institutions could affect the calculation of their insurance premiums. Seven others expressed similar concerns in comment letters to FDIC. In its final rule, FDIC stated that while the pricing method is complex, its application is straightforward. For example, if an institution's capital declines, its premium will likely increase. Further, FDIC officials said that the FDIC Web site contains a rate calculator that allows an institution to determine its premium and to simulate how a change in the value of debt ratings, supervisory ratings, or financial ratios would affect its premium.

Officials we interviewed from all three of the large banks said that the level and range of premiums for top-rated institutions generally was too high, given the actual risk they believe their institutions pose to the insurance fund. Officials from one large bank and one trade association we spoke with said that the best-rated banks and thrifts should pay no premiums, or that the base rate range of premiums should be reduced from 2 to 4 to 1 to 3 basis points. An additional nine organizations supported similar changes in their comment letters. Risk category I, the top-rated premium category, accounts for the majority of total deposits, meaning that even small changes in premium assessment rates could produce a significant difference in revenue to the insurance fund, and hence assessments to the industry. FDIC officials said that the 2 to 4 basis point spread is more likely to satisfy the insurance fund's long-term revenue needs than a 1 to 3 basis point spread. FDIC officials also said that FDIC could, based on authority in the final rule, reduce rates below the current base rate “floor” of 2 to 4 basis points if the agency determined that such a reduction was warranted.

Further, one bank official we spoke to said that the new system was incorrectly based in the idea of institutions failing, rather than on the more nuanced notion of actual losses expected to be suffered by the deposit insurance fund if failures occurred. As a result, he said, FDIC failed to give appropriate credit to how large banks handle risk. Three organizations that submitted comments on FDIC’s new system supported this notion, saying that FDIC should not assess premiums on all domestic deposits because losses suffered by uninsured depositors should impose no burden on the insurance fund—the magnitude of any loss would be lessened to the extent that depositors in foreign branches, other uninsured depositors, general creditors, and holders of subordinated debt absorbed such losses.[66] FDIC officials, citing research the agency has done on failures and losses, said that the differences in rates and categories were empirically based, and thus adequately reflected all institutions’ risk. Further, FDIC officials said that loss severity is one of the many factors the agency is permitted to consider as part of its assessment of the risk of large institutions.

Officials from the two small banks, one large bank, and both industry trade groups and the academics with whom we spoke questioned FDIC’s choice on initial placement of institutions into risk categories. Because most institutions are now healthy, FDIC placed them into the best-rated premium category, risk category I, for which base rate premium charges range from 2 to 4 basis points. Within this top-rated category, FDIC initially assigned approximately 45 percent of institutions to receive the minimum rate of 2 basis points, and 5 percent of institutions to receive the highest rate of 4 basis points. The remainder fell in the middle of the range. These officials and academics generally agreed that FDIC should establish risk criteria, and then assign institutions to appropriate groups based on those criteria, rather than start with a predetermined distribution in mind. Three additional organizations expressed similar concerns in comment letters to FDIC. Further, officials from the other two large banks with whom we spoke said that given the economic good times and institutional good health, the 45 percent of institutions with the lowest rate was too small a grouping and, as a result, healthy institutions arbitrarily would be bumped into higher premiums. FDIC officials said that based on the

[66]FDIC officials said that such changes were not within the scope of this redesign of the deposit insurance system.

agency's experience, a range of 40 to 50 percent appeared to be a natural breaking point in the distribution of institutions by risk, and that over time, the percentage of institutions assigned the lowest premium in the top-rated category may vary.

Some also thought the new system had the potential to create tension or discourage cooperative relations between bank management and federal examiners. Under the old system, there was no difference in premiums for well-capitalized, 1-rated institutions and well-capitalized 2-rated institutions. However, under the new system, such a difference could lead to higher premiums because CAMELS ratings are factored into premium calculations. As a result, according to officials we interviewed from one trade group, management might be less willing to discuss with examiners issues or problems that could prompt a lower rating, although raising and resolving such problems ultimately might be good for both the institution and the insurance fund. FDIC officials acknowledged the concern, and said that FDIC and the other federal regulators plan to monitor the new system for adverse effects. However, they said that it was important to include CAMELS ratings in the assessment of risk because the ratings provide valuable information about institutions' financial and operational health.

Finally, officials from one trade association and one of the large banks with whom we spoke also expressed concern that regional or smaller institutions could be disadvantaged under the new system. Officials from two credit rating agencies echoed this view, saying that larger, more diverse institutions (by virtue of factors such as revenue, geography, or range of activities) typically have steadier income, which increases security and decreases risk. In contrast, regional or smaller institutions can have geographic or line-of-business concentrations in their lending portfolios that could hurt supervisory or credit ratings, leading to higher deposit insurance premiums. FDIC said that while size or geography could affect an institution's risk profile, management could offset that risk by maintaining superior earnings or capital reserves, requiring higher collateral requirements on loans, or using hedging vehicles.

FDIC officials told us that the agency plans to monitor the new deposit insurance system to ensure its proper functioning and the fair treatment of the institutions that pay premiums into the deposit insurance fund. For example, in addition to assessing whether the new system creates friction between examiners and bank and thrift management, as discussed above, FDIC officials also said that the agency will, among other things, assess over time whether the percentage of institutions paying the lowest rate in risk category I—those receiving the best premium rate—should be increased and whether different financial ratios should be considered in the calculation of premiums.

Agency Comments

We provided FDIC, the Federal Reserve, OCC, and OTS with a draft of this report for their review and comment. In written comments, the Federal Reserve concurred with our findings related to PCA. These comments are reprinted in appendix II. The Federal Reserve noted that PCA has substantively enhanced the agency's authority to resolve serious problems expeditiously and that PCA has generally worked effectively in the problem situations where its use became applicable. In addition, FDIC, the Federal Reserve, and OCC provided technical comments, which we incorporated as appropriate.

We are sending copies of this report to the Chairmen of the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, and interested congressional committees. We will also make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions concerning this report, please contact me at (202) 512-8678 or at jonesy@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix III.

Yvonne D. Jones

Yvonne D. Jones
Director, Financial Markets
and Community Investment

Appendix I: Objectives, Scope, and Methodology

The objectives of this report were to (1) describe trends in the financial condition of banks and thrifts and federal regulators' oversight of these institutions since the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), (2) evaluate how federal regulators used the capital or prompt corrective action (PCA) provisions of FDICIA to resolve capital adequacy issues at the institutions they regulate, (3) evaluate the extent to which federal regulators use the noncapital provisions of FDICIA to identify and address weaknesses at the institutions they regulate, and (4) describe the Federal Deposit Insurance Corporation's (FDIC) deposit insurance system and how recent changes to the system affect the determination of depository institutions' risk and insurance premiums. Our review focused on FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) and was limited to depository institutions.

To describe trends in the financial condition of banks and thrifts, we summarized financial data (including total assets, net income, returns on assets, returns on equity, the number of problem institutions, and the number of bank and thrift failures) from 1992, the year FDICIA was implemented, through 2005. We obtained this information from FDIC Quarterly Banking Reports, which publish industry statistics derived from Reports on Condition and Income (Call Report) and Thrift Financial Reports. All banks and thrifts must file Call Reports and Thrift Financial Reports, respectively, with FDIC every quarter. We also analyzed Call and Thrift Financial Report data for 1992 through 2005 that FDIC provided to determine (1) the number of well-capitalized, adequately capitalized, undercapitalized, significantly capitalized, and critically undercapitalized depository institutions from 1992 through 2005 and (2) the amount of capital well-capitalized banks and thrifts carried in excess of the well-capitalized leverage capital minimum for each year from 1992 through 2005.[1] We chose to use Call and Thrift Financial Report data because the data are designed to provide information on all federally insured depository institutions' financial condition, and FDIC collects and reports the data in a standardized format. We have tested the reliability of FDIC's Call and Thrift Financial Report databases as part of previous studies and

[1]Leverage capital is tier 1 capital computed without risk weights and in most cases closely matches an institution's reported tangible equity. If an institution's tangible equity is 2 percent or less, it is considered critically undercapitalized for PCA purposes.

found the data to be reliable.[2] In addition, we performed various electronic tests of the specific data extraction we obtained from FDIC and interviewed FDIC officials responsible for providing the data to us. Based on the results of these tests and the information we obtained from FDIC officials, we found these data to be sufficiently reliable for purposes of this report.

To describe federal regulators' oversight of banks and thrifts since the passage of FDICIA, we reviewed the provisions of the Federal Deposit Insurance Act (FDIA) requiring regulators to conduct annual, on-site, full-scope examinations of depository institutions as well as several GAO and industry reports discussing the federal regulators' oversight of depository institutions prior to the failures of the 1980s and early 1990s and after the enactment of FDICIA, including their use of PCA to address capital deficiencies.[3] We also obtained data from each of the four federal regulators on the interval between examinations for each year, from 1992 through 2005. We interviewed officials from FDIC, the Federal Reserve, OCC, and OTS to assess the reliability of these data. Based on their responses to our questions, we determined these data to be reliable for purposes of this report.

To determine how federal regulators used PCA to address capital adequacy issues at the institutions they regulate, we reviewed section 38 of FDIA, related regulations, regulators' policies and procedures, and past GAO reports on PCA to determine the actions regulators are required to take when institutions fail to meet minimum capital requirements.[4] We then analyzed Call and Thrift Financial Report data to identify all banks

[2]For example, see GAO, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, GAO-05-621 (Washington, D.C.: Sept. 15, 2005), 87. In addition, we confirmed that no significant changes occurred to the way in which banks and thrifts report information on their financial condition and how FDIC maintains the data since the release of this report.

[3]Pub. L. No. 102-242 § 111(a), 105 Stat. 2236, 2240 (1991) (codified as amended at 12 U.S.C. § 1820(d)). GAO, *Bank Supervision: Prompt and Forceful Regulatory Actions Needed*, GAO/GGD-91-69 (Washington, D.C.: Apr. 16, 1991); GAO, *Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions*, GAO/GGD-97-18 (Washington, D.C.: Nov. 21, 1996); Federal Deposit Insurance Corporation Office of the Inspector General, *The Role of Prompt Corrective Action as Part of the Enforcement Process*, Audit Report No. 03-038 (Washington, D.C.: Sept. 12, 2003); and Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future* (Washington, D.C.: 1997).

[4]GAO/GGD-91-69 and GAO/GGD-97-18.

and thrifts that were undercapitalized, significantly undercapitalized, or critically undercapitalized (the three lowest PCA capital categories) during at least one quarter from 2001 through 2005. We chose this period for review based on the availability of examination- and enforcement-related documents and to reflect the regulators' most current policies and procedures. From the 157 institutions we identified as being undercapitalized or lower from 2001 to 2005, we selected a nonprobablity sample of 24 institutions, reflecting a mix of institutions supervised by each of the four regulators and institutions in each of the three lowest PCA capital categories. We reviewed their reports of examination, informal and formal enforcement actions, and institution-regulator correspondence for a period covering four quarters prior to and four quarters following the first and last quarters in which each institution failed to meet minimum capital requirements to determine how regulators used PCA to address their capital deficiencies. As discussed above, we have tested the reliability of Call and Thrift Financial Report data and found the data to be reliable. To supplement our sample, we also reviewed material loss reviews from 14 banks and thrifts that failed with material losses from 1992 through 2005 and in which regulators used PCA to address capital deficiencies.[5] Because of the limited nature of our sample, we were unable to generalize our findings to all institutions that were or should have been subject to PCA since 1992.

To determine the extent to which federal regulators have used the noncapital supervisory actions of sections 38 and 39 of FDIA to address weaknesses at the institutions they regulate, we reviewed regulators' policies and procedures related to sections 38(f)(2)(F) and 38(g)—the provisions for dismissal of officers and directors and reclassification of a capital category, respectively—and section 39, which gives regulators authority to address safety and soundness deficiencies. We analyzed regulator data on the number of times and for what purposes the regulators used these noncapital authorities. To provide context on the extent of regulators' use of these noncapital provisions, we also obtained data on the number of times regulators used their authority under section 8(e) of FDIA to remove officers and directors from office and section 8(b)

[5]Section 38(k) of FDIA requires the federal regulators' respective inspectors general to issue reports on each depository institution whose failure results in a "material loss"—losses that exceed $25 million or 2 percent of an institution's assets, whichever is greater—to the insurance fund. These material loss reports must assess why the institution's failure resulted in a material loss and make recommendations for preventing such losses in the future.

of FDIA to enforce compliance with safety and soundness standards. Based on regulators' responses to our questions related to these data, we determined the data to be reliable for purposes of this report.

Finally, to describe how changes in FDIC's deposit insurance system affect the determination of institutions' risk and insurance premiums, we reviewed FDIC's notice of proposed rule making on deposit insurance assessments, selected comments to the proposed rule, and FDIC's final rule on deposit insurance assessments.[6] We also interviewed representatives of three large institutions, two small institutions, and two trade groups representing large and small institutions and two academics to obtain their views on the impact of FDIC's changes to the system. We selected the large institutions based on geographic location and size and the small institutions based on input from the Independent Community Bankers Association on which of its member organizations were familiar with FDIC's proposed changes to the deposit insurance system. We also interviewed officials from two credit rating agencies on the factors—financial, management, and operational—they consider when rating institutions' debt offerings.

We conducted our work in Washington, D.C., and Chicago from March 2006 through January 2007 in accordance with generally accepted government auditing standards.

[6]Federal Deposit Insurance Corporation—Assessments, 71 Fed. Reg. 41910 (2006) (proposed rule). Comments to the proposed rule making were due on September 22, 2006. Federal Deposit Insurance Corporation—Assessments, 71 Fed. Reg. 69282 (2006) (final rule codified at 12 C.F.R. pt. 327.9, 327.10 and Appendixes A, B, and C of Subpart A).

Appendix II: Comments from the Board of Governors of the Federal Reserve System

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

ROGER T. COLE
DIRECTOR
DIVISION OF BANKING SUPERVISION
AND REGULATION

January 12, 2007

Ms. Yvonne Jones
Director, Financial Markets and Community Investment
United States Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Ms. Jones:

Thank you for the opportunity to review and comment on the Government Accountability Office (GAO's) draft report entitled. *Deposit Insurance – Assessment of Regulators' Use of Prompt Corrective Action Provisions and FDIC's New Deposit Insurance System*. The report (1) examines how regulators have used Prompt Corrective Action (PCA) to resolve capital adequacy issues at depository institutions; (2) assesses the extent that regulators have used noncapital supervisory actions under sections 38 and 39; and (3) describes how recent changes to the FDIC's deposit insurance system affect the determination of institutions' insurance premiums.

Based upon our agency's supervisory experience, the Federal Reserve concurs with the GAO's findings relating to PCA. As noted in the report, the Federal Reserve and other agencies have typically taken supervisory action well in advance of PCA becoming effective. Nonetheless, we believe that the PCA provisions enacted in 1991 have substantively enhanced the Federal Reserve's authority to resolve serious problems expeditiously. While banking conditions have been exceptionally strong since PCA was enacted, the PCA provisions implemented by the Federal Reserve have generally worked effectively in the relatively few problem situations where they became applicable. As the report notes, although the Federal Reserve, to date, may not have utilized all of the provisions of PCA given alternative authorities and supervisory tools, circumstances in the future may differ and enhance the utility of these provisions. In addition to the foregoing, we note that the mandatory nature of many of the PCA remedial actions required to be taken by a primary federal regulator against an insured depository institution in an impaired financial condition may serve as a powerful incentive for insured depository institutions to maintain strong capital positions.

We very much appreciate the depth of the GAO's review of actual cases subject to PCA, and the opportunity to comment on the findings. The Federal Reserve has no comments on the portion of the report relating to the recent changes to the FDIC's deposit insurance system.

Sincerely,

Roger T. Cole

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Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Yvonne D. Jones, (202) 512-8678 or jonesy@gao.gov

Acknowledgments

In addition to the contact named above, Kay Kuhlman, Assistant Director; Gloria Hernandez-Saunders; Wil Holloway; Tiffani Humble; Bettye Massenburg; Marc Molino; Carl Ramirez; Omyra Ramsingh; Barbara Roesmann; Cory Roman; and Christopher Schmitt made key contributions to this report.

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