

REPORT TO THE CONGRESS ON PROMPT CORRECTIVE ACTION

FINANCIAL STABILITY OVERSIGHT COUNCIL

Completed pursuant to Section 202(g)(4) of the Dodd-Frank Wall Street Reform and Consumer Protection Act

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I. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) requires the Financial Stability Oversight Council (the “Council”) to submit a report to Congress regarding the implementation of prompt corrective action (“PCA”) by the Federal banking agencies.¹ More specifically, section 202(g)(4) of the Dodd-Frank Act requires the Council to issue a report on actions taken in response to the GAO study required by section 202(g)(1) of the Dodd-Frank Act. This report discusses the existing PCA framework and the findings and recommendations of the GAO study. It also highlights some lessons learned from the financial crisis and outlines actions taken that could affect PCA, as well as additional steps to modify the PCA framework that could be considered.

II. PCA Statutory and Regulatory Framework

The Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”) created the PCA framework embodied in section 38 of the Federal Deposit Insurance Act (“FDIA”). In accordance with the mandate of the FDICIA, the Federal banking agencies conducted a joint rulemaking and adopted uniform rules to implement the PCA statutory framework. The Federal banking agencies’ rules established capital ratio criteria for the five capital categories under the statutory PCA framework and set forth the mandatory and discretionary actions for the agencies to address problems of banks in each capital category. Under the statutory PCA framework the Federal banking agencies are charged with the identification of problems of financially troubled banks at an early stage. The boards of directors and management of financially troubled banks are required to take prompt action as directed by the relevant agencies to remedy identified deficiencies.

The PCA framework includes five capital categories keyed to the Federal banking agencies’ current risk-based and leverage capital requirements.² The PCA framework provides more stringent mandatory and discretionary actions to be taken by the Federal banking agencies in addressing the problems of a bank as it falls into lower PCA categories. The primary Federal banking agency also is authorized to reclassify a bank to a lower PCA category, after notice and opportunity for hearing, upon determining that (i) the bank is operating in an unsafe and unsound

¹ The Federal banking agencies are the Federal Reserve Board (“FRB”), the Federal Deposit Insurance Corporation (“FDIC”), and the Office of the Comptroller of the Currency (“OCC”).

² “Well capitalized” (equals or exceeds a 10 percent total risk-based capital ratio, 6 percent tier 1 risk-based capital ratio, and 5 percent leverage ratio); “adequately capitalized” (equals or exceeds an 8 percent total risk-based capital ratio, 4 percent tier 1 risk-based capital ratio, and 4 percent leverage ratio); “undercapitalized” (total risk-based capital ratio of less than 8 percent, or a tier 1 risk-based ratio of less than 4 percent, or a leverage ratio of less than 4 percent (3 percent for institutions with a CAMELS rating of 1 that do not evidence rapid growth or other heightened risk indicators)); “significantly undercapitalized” (total risk-based capital ratio of less than 6 percent, or a tier 1 risk-based capital ratio of less than 3 percent, or a leverage ratio of less than 3 percent) and “critically undercapitalized” (a ratio of tangible equity to total assets equal to or less than 2 percent). Tangible equity is defined in the PCA rule as the amount of core capital elements under the Federal banking agencies’ rules plus cumulative perpetual preferred stock minus all intangible assets other than mortgage servicing assets to the degree included in tier 1 capital under the banking agencies rules.

condition or (ii) the bank received and has not corrected a less-than-satisfactory rating for any of the categories of asset quality, management, earnings, or liquidity.

Banks in any three of the less than adequately capitalized categories are subject to the provisions of section 38 of the FDIA restricting payment of management fees, requiring submission of a capital restoration plan, restricting growth, and requiring prior approval of certain expansion proposals. A bank that is significantly undercapitalized or critically undercapitalized or shows other signs of deterioration also may be directed to recapitalize itself (for example, by raising additional capital or being acquired by another banking organization), replace its directors and senior officers, make certain divestitures, and restrict compensation paid to senior executive officers. In addition, if a bank is critically undercapitalized, the PCA framework generally prohibits the payment of interest on subordinated debt. Furthermore, no later than 90 days after a bank becomes critically undercapitalized, its primary Federal banking agency shall either (i) appoint a receiver or (ii) require other action (for an extendable period up to an additional 180 days) that it determines, with the consent of the FDIC, better achieves the purposes of the PCA framework.

In accordance with the requirements of section 39 of the FDIA, the Federal banking agencies adopted rules that set safety and soundness standards for criteria other than capital, including earnings, asset quality, compensation, and management. These rules provide authority for the Federal banking agencies to require corrective action if a bank fails to satisfy one or more of these standards.

III. The GAO Study

Under section 202(g)(1)-(3) of the Dodd-Frank Act, the GAO must conduct a study regarding the implementation of PCA by the Federal banking agencies. The GAO study must evaluate ways to make PCA a more effective tool to resolve insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund (“DIF”), the effectiveness of implementation of PCA by the appropriate Federal banking agencies, and the resolution of insured depository institutions by the FDIC.

The GAO study, released in June 2011, concluded that the existing PCA framework did not prevent widespread losses to the DIF, and that losses to the DIF as a result of the failure of banks that were subjected to PCA enforcement actions before failure were comparable as a percentage of assets to the losses of failed banks that were not subjected to PCA enforcement actions. The GAO study notes that “[c]apital can lag behind other indicators of bank health,”³ and, in light of this and other aspects of the PCA framework, the GAO recommends that alternative PCA triggers be considered, including indicators based on earnings, asset quality, liquidity, reliance on unstable funding, and sector loan concentration.

As part of the GAO study, the GAO surveyed various expert stakeholders. These expert stakeholders identified potential modifications to the PCA framework that could enhance its effectiveness, including (i) adding a measure of risk to the capital category thresholds, (ii)

³ GAO study, at 23.

increasing the capital ratios that place banks into PCA capital categories, and (iii) adding an additional trigger. The GAO study acknowledges advantages and disadvantages associated with each of the potential alternative triggers identified and various challenges related to considering whether additional triggers or other enhancements could be developed.

To improve the effectiveness of the PCA framework, the GAO recommended that the Federal banking agencies consider additional triggers that would require early and forceful regulatory actions tied to specific unsafe banking practices and also consider the other two options—adding a measure of risk to the capital category thresholds and increasing the capital ratios that place banks into PCA capital categories—identified in the GAO study. In considering such improvements, the GAO also recommended that the Federal banking agencies should work through the Council to make recommendations to Congress on how PCA should be modified.

As the Federal banking agencies have noted in their comments to the GAO study, future increases to the Federal banking agencies' minimum capital requirements could lead to increased capital thresholds in each PCA category, and enhancements to these capital standards likely will be considered as the Federal banking agencies implement capital requirements, consistent with the Basel 2.5 and III accords and the Dodd-Frank Act, as discussed below.

IV. Lessons Learned During the Financial Crisis

As the GAO study points out, between 2007 and 2010, bank health deteriorated precipitously, as reflected by the rapid growth in and high number of banks on the FDIC's problem bank list and the number of troubled banks with CAMELS composite ratings of 3, 4 and 5. This period of stress in the banking sector tested the limits of PCA's effectiveness in a way not seen since PCA was introduced by the FDICIA. PCA is just one element that supervisors have been examining as they consider supervisory lessons learned from the financial crisis. The GAO report and the responses of the Federal banking agencies describe a number of supervisory enhancements already adopted or planned. In this vein, as regulators consider whether the PCA framework should be modified or enhanced, they will be working to implement a key lesson learned from the crisis – specifically, that the quality of capital and minimum capital requirements should be enhanced, as embodied in the Dodd-Frank Act, Basel 2.5 and Basel III.

Implementation of Basel 2.5, Basel III, and the Dodd-Frank Act Enhanced Prudential Standards

In light of lessons learned from the crisis, the United States and other countries acting together through the Basel Committee on Banking Supervision (“Basel Committee”) have developed more stringent capital requirements for internationally active banking organizations. Consistent with the Federal banking agencies' comments to the GAO study, the agencies are in the process of developing rules to implement the enhanced capital standards adopted by the Basel Committee. These enhanced capital standards were agreed upon by the Federal banking agencies and other countries participating in the Basel Committee and were endorsed by the Financial Stability Board (“FSB”) and the G-20. The standards are intended to ensure that banks have strong capital bases from both micro-prudential and macro-prudential perspectives.

Basel 2.5, adopted by the Basel Committee in mid-2009, addresses the capital shortfalls in banking organizations' trading books, as experienced in the financial crisis, by significantly increasing capital requirements for banks' trading activities and assets held in their trading books. Basel III, which was agreed upon by the United States and other members of the Basel Committee in December 2010, increases banks' required levels of common equity. When the new rules are fully phased in there will be a common tier 1 requirement of 4.5 percent of risk-weighted assets and a capital conservation buffer of 2.5 percent (7 percent in aggregate) of risk-weighted assets, also required to be satisfied solely with common equity less required deductions (e.g., intangible assets and deferred tax assets). In addition, Basel III improves the quality of tier 1 and tier 2 capital by excluding certain instruments that do not satisfy the prudential criteria set by Basel III. Furthermore, Basel III includes the first internationally applicable leverage ratio. Another major action of the Basel Committee and the FSB, as endorsed by the G-20, is the release of the framework for determining global systemically important banks (G-SIBs). Banking organizations designated as G-SIBs will be required to hold additional capital buffers equaling from 1 percent to 2.5 percent of risk-weighted assets, depending on an assessment of each G-SIB's relative global position. In addition, Basel III requires earlier constraints on capital distributions if the capital conservation buffer is not maintained. The Federal banking agencies are developing proposals to implement the various Basel capital reforms in the United States.

The FRB and FDIC indicated in their comments to the GAO study that the implementation of Basel III could affect the capital thresholds incorporated in the Federal banking agencies' current PCA standards. Furthermore, the Dodd-Frank Act requires the FRB to adopt enhanced prudential standards for bank holding companies with total consolidated assets equal to or greater than \$50 billion and nonbank financial companies designated by the Council for FRB supervision. These standards cover various supervisory factors including risk-based capital requirements.

Evaluation of the Need for Modifications to PCA

A thorough evaluation of the PCA framework and consideration of the need for changes should take into account the enhancements to capital and prudential standards described above, as well as the PCA framework's effectiveness through the entirety of the cycle that began with the deterioration of bank health in 2007. Thus, when indicators of bank health, like the level of troubled and problem banks, show significant improvement, the regulators should consider the effectiveness of PCA and other supervisory tools in the context of the complete business cycle and any new capital standards that have been implemented. A review that takes into account these factors will be able to more fully measure the PCA framework's effectiveness in mitigating the effect of bank failures, and therefore will provide a better opportunity to consider potential enhancement options based on complete data. In addition, section 166 of the Dodd-Frank Act requires the FRB to develop an early remediation regime for bank holding companies with total consolidated assets of \$50 billion or greater and any nonbank financial companies designated by the Council for supervision by the FRB. Importantly, section 166 requires the FRB to include "liquidity measures, and other forward-looking indicators" in addition to regulatory capital in the early remediation framework. While section 166 and the PCA framework are separate, implementation of new rules under section 166 could provide regulators with additional experience to inform potential modifications to the PCA framework.

V. The Council's Actions since the Release of the GAO Study

The Council has considered the recommendations made in the GAO study, and will provide a forum where the banking regulators can discuss potential future enhancements to the PCA framework that they may want to consider. The Council is providing a forum for interagency consultation and coordination as the FRB develops an approach to implement the enhanced prudential standards and early remediation standards under the Dodd-Frank Act, and these new standards could provide valuable insights as regulators consider potential modifications to the PCA framework.

When evaluating potential modifications to the PCA framework for non-capital related triggers, the Council suggests that the Federal banking agencies consider data available after the current cycle in the banking sector has shown sufficient improvement. Moreover, while regulators acknowledge the potential weaknesses in using capital as a measure for the PCA framework, the manner in which any modifications to PCA are constructed to include alternative triggers in addition to capital will need to be carefully considered to be successful, as the GAO study also recognizes. In developing any potential enhancements to the PCA framework, the Council believes that the following principles, which are reflected in the existing PCA framework, continue to be carefully considered:

- PCA triggers should be objective to provide predictability.
- PCA triggers and accompanying corrective action should serve to reduce the likelihood and cost of bank failures, and accordingly must be carefully designed not to speed a bank's descent into an otherwise avoidable failure.
- PCA triggers should be based on broadly applicable financial metrics that do not discriminate against banks in particular size categories, geographies or business models. For example, the PCA framework should be cognizant of the differences in asset-type, concentration, and risk management for community banks when compared to larger financial institutions.
- PCA should complement a supervisory approach that encourages banks to improve their condition before severe automatic supervisory actions are required.
- Measures used in PCA should continue to have an automatic element that can provide a backstop to the existing supervisory framework, with an aim of ensuring prompt action to reduce the likelihood and cost of bank failures.

Section 202(g) of the Dodd-Frank Act also requires the Council to report on any recommendations made to the Federal banking agencies under section 120 of the Act. As of the date of this report, the Council has not made any such recommendations.