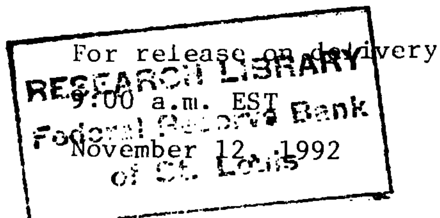
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"Prompt Corrective Action: Effects on the Banking Industry"

by

Edward W. Kelley, Jr.

Member

Board of Governors of the Federal Reserve System

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We are here this morning to discuss one of the most important provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991, prompt corrective action, and the effects it will have on the banking industry and regulators alike. As you know, the prompt corrective action framework specifies actions that regulators must take -- and other action they must consider taking -- when the capital position of an insured depository institution declines. These actions impose increasingly severe restrictions on institutions as they become more seriously undercapitalized. Conversely, those institutions that are well capitalized are being granted certain advantages in the implementation of other provisions of FDICIA. There are a range of other provisions in FDICIA aimed at strengthening the regulation and supervision of insured depository institutions, and these provisions, together with the new prompt corrective action framework, will work to provide more effective supervision of depository institutions, thus reinforcing the safety net and stability of the financial system.

Emergence of Prompt Corrective Action

I think it would be helpful to begin by briefly discussing how

prompt corrective action came into being. The thrift crisis of the 1980's and the well-publicized commercial banking problems of that decade caused many to question certain aspects of the federal safety net and the ways regulators dealt with troubled institutions. There was a view held by many that supervisors of insured depository institutions were slow to identify troubled institutions and were inclined to exercise too much forbearance in working with institutions with serious problems. It was concluded that, on occasion, steps were not taken promptly to address deficiencies, so that problems were allowed to fester, dividends were not prudently curtailed, and cost-cutting and other remedial measures were delayed.

There was also concern that management and owners of undercapitalized institutions with little, if any, of their own equity on the line, were inclined to gamble with government-guaranteed deposits in the quest for speculative profits that would facilitate a quick turnaround. Also, because of deposit insurance, institutions inclined to take such gambles were not deterred by the normal disciplinary forces of the marketplace. In short, a consensus developed that there was a need for a better supervisory framework, one that would assure that supervisors would deal promptly and effectively with problems of insured depository institutions in order to

protect the deposit insurance fund and to promote stability in our financial system.

It is not my purpose here today to discuss to what extent these various criticisms may or may not have been valid. It is sufficient for our discussion to know that they were shared by the Administration, the Congress, and the public. Out of this environment came the view that the regulators needed added legislative authority and guidance to ensure that they could and would take appropriate corrective action in the early stages of the deterioration in a depository institution's condition and to close seriously undercapitalized institutions that are destined to fail, before they actually become insolvent. A 1991 Treasury study entitled "Modernizing the Financial System" reflected these views and bills were introduced in the Congress to modify the regulatory structure along these lines.

Provisions of Prompt Corrective Action

Congress subsequently acted, setting up a capital-based framework for prompt corrective action as part of FDICIA. Within this framework, which becomes effective December 19th, all depository institutions are assigned to one of five capital categories: well capitalized,

adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Consistent with Congressional instruction, for each of these categories the regulators have specified threshold levels of capital defined in terms of our established risk-based and leverage capital standards. An institution's capital ratios, however, are not the sole determinant of the prompt corrective action category to which an institution is assigned. The statute affords supervisors the flexibility to downgrade an institution into a lower category based on certain non-capital factors, which I will discuss later. As an institution's capital declines, activating the threshold tripwires for each successively lower capital category, or is downgraded by supervisory action to a lower capital category, the institution becomes subject to increasingly stringent regulatory actions, some mandatory and some discretionary.

Banks whose capital ratios drop into the undercapitalized category will be required to cease paying dividends and to promptly file a capital restoration plan that incorporates specific restraints on the growth rate of the institution. The intent here is to require a weakening institution to address its problems quickly and aggressively. Those that fall into the significantly undercapitalized category will be subject to a range of

supervisory measures, including being required to raise capital immediately or merge with another institution; to strengthen management by electing new directors or firing existing officers or directors; to severely restrict growth; and to alter, reduce, or terminate any activity when the supervisor deems it appropriate. At least one of these actions must be ordered by the supervisor.

Finally, and perhaps the most significant of all the provisions, if an institution becomes critically undercapitalized -- that is, if its tangible book equity capital ratio drops to two percent or less -- its primary supervisor must seize it and put it into conservatorship or receivership. This provision represents the most radical change from earlier practice. In the past, the chartering authority generally had to wait until an institution's book capital dropped to zero before it could act. This potent new enforcement power requires that an insured depository institution be placed into receivership or conservatorship within 90 days of becoming critically undercapitalized. A deviation from this requirement must be mutually agreed to by the institution's primary federal regulatory authority -- the Federal Reserve in the case of state member banks -- and the FDIC. And, any such agreement cannot defer indefinitely the winding up of the

institution's affairs. An institution which continues to be critically undercapitalized must eventually be placed into receivership.

The thought behind the new provision, obviously, is to act before all capital is gone and, thus, to protect the insurance fund against loss. I would offer that this provision will not assure that the FDIC will never suffer a loss or never suffer a large loss. As we have seen, eroding asset values in a weakening economic environment can move an institution's capital position from the significantly positive to the significantly negative very quickly, and nothing can be done about that -- by the regulators or anyone else. Nonetheless, this provision will provide a means to avoid delay in closing seriously impaired institutions and will help to reduce the FDIC's loss exposure.

As for the other provisions of the prompt corrective action framework, supervisors have long had the authority to take any of the other actions specified by the legislation. But I believe it is clear that we will now move more quickly and decisively than was generally the case in the past. Given the uncertainty that can surround troubled situations, in the past supervisors may have too often given institutions the benefit of the doubt by allowing time to pass to see how events would unfold before acting and

thus, for example, in some cases allowed dividends to be paid after they should have stopped.

In talking about prompt corrective action, it is important to also consider the many other provisions of FDICIA that were designed to enhance supervisory powers and practices. These other measures include mandating annual full-scope examinations, an expanded role for auditors, a range of new standards for lending and operations, and a call to give expanded consideration to risks other than credit risk -- such as interest rate risk -- in assessing a bank's capital position. These provisions, taken together with the prompt corrective action framework, have greatly strengthened the hand of the supervisors of depository institutions. Indeed, in my opinion, the law goes too far and, in the case of several important provisions, supervisors will be too deeply involved in the micromanagement of depository institutions. I intend to return to this subject at the end of my talk.

Rewards for well capitalized institutions

Up to now, I have been talking about the "stick" associated with prompt corrective action. What about the "carrot?" The Federal Reserve in

its support for the prompt corrective action framework envisioned that it would be established within the context of broader financial reforms that would grant strongly capitalized institutions greater flexibility in their operations and freedom from certain regulatory constraints. Two examples of the carrots the Federal Reserve advocated for well capitalized institutions were expanded powers to engage in securities activities and the authority to branch across state lines.

As the legislation proceeded through the Congress, the comprehensive approach we favored began to be chipped away. In the end all proposals to expand banking powers and eliminate restrictions on interstate banking were discarded, and, thus, the more profound rewards for being well capitalized have not yet been granted by the Congress.

In adopting other sections of FDICIA, however, the agencies have endeavored to accord favorable treatment to well capitalized institutions. For example, the FDIC was given authority to regulate brokered deposits, and the regulation it adopted specifies that well capitalized institutions can accept brokered deposits without restriction. Adequately capitalized institutions can do so after gaining the FDIC's permission, while those more poorly capitalized cannot do so at all. Also,

the FDIC has adopted a risk-based deposit insurance premium rate schedule that levies lower premiums on well capitalized institutions. And in a regulation the Federal Reserve will soon be adopting which is intended to control the risks of systemic problems potentially arising from interbank liabilities, correspondent banking relationships will be less inhibited when correspondent banks are more strongly capitalized. As the agencies draft additional regulations to meet the many mandates of FDICIA, they are giving consideration to other ways of encouraging banks to become well capitalized. Ways are being sought for banks with a stronger capital base to be freed from certain regulatory constraints and burdens and be freed to take advantage of expanded opportunities in the financial marketplace.

Issues surrounding the implementation of Prompt Corrective Action

While the basic framework of prompt corrective action is in place, there are still a few important issues that will have to be addressed as we move to implement the system.

One of these issues is the question of the extent to which supervisors will be prepared to use their authority to downgrade institutions into a lower capital category. Supervisors may exercise this authority when

an institution engages in an unsafe and unsound practice (as reflected by the institution receiving an unsatisfactory examination rating for poor asset quality, management deficiencies, poor earnings, or lack of liquidity) or is determined to be in an unsafe and unsound condition. The regulation requires that the agencies must notify an institution that they intend to downgrade it and provide for an informal hearing before that action is effective.

The issue to be resolved is the extent to which this downgrading authority is to be used. Some have argued that the capital focus of prompt corrective action has significant drawbacks because there are other factors that are not taken into account that can importantly effect the condition of an institution. Those holding this view say that Congress was aware of this since the authority to downgrade is embodied in FDICIA, and they would be strongly inclined to have the agencies use the authority to downgrade institutions in cases where there are non-capital problems.

Others hold the view that since FDICIA did not eliminate any of the agencies' traditional supervisory and enforcement powers, non-capital deficiencies need not be addressed under the formal prompt corrective action framework, but rather can be addressed directly through memoranda

of understanding, cease and desist orders, or other traditional enforcement techniques. In their opinion, there is little point in going through the added step of downgrading an institution when the same enforcement powers could be used just as effectively outside of the prompt corrective action framework.

A second issue that arises from the capital-based focus of prompt corrective action is the need for an accurate measurement of capital. That, in turn, requires that reserves set aside for loan losses be maintained at a level sufficient to cover anticipated losses. The adequacy of loan loss reserves has always been important, but has taken on added emphasis over the last decade as the regulatory capital standards changed from a primary capital formula to the risk-based and leverage standards. It becomes even more important with the advent of the prompt corrective action framework, under which supervisory responses are based primarily on the new capital categories. With that in mind, the regulatory agencies, under the auspices of the Federal Financial Institutions Examination Council, have been engaged in a major project to consider what the agencies might do to enhance the ability of examiners to assess the reserving practices of depository institutions.

A third question that will have to be addressed as we proceed to implement prompt corrective action concerns the nature of those capital restoration plans calling for issuance of new capital or merger with other institutions, which supervisors may require from institutions with capital deficiencies. On the one hand, some authorities believe that institutions should be required to achieve a recapitalization expeditiously even under conditions in which the market price of its stock has recently dropped sharply due to its problems. Those holding this position would say that while the conditions are obviously not ideal for issuing stock and that such issuance will result in dilution of existing shareholders, new capital can be raised at some price and regulators should require such action to protect the deposit insurance fund.

On the other hand, there are those who believe that in many cases it would be appropriate to follow a conservative approach to achieving recapitalization of a troubled institution. Those on this side are concerned about the impact that coming to market under such adverse conditions could effect the institution's liquidity, compounding its problems and jeopardizing it ultimate recovery.

The primary legal issues raised by the prompt corrective action

framework center around assuring that each institution has adequate notice of its capital category and has an opportunity to be heard in connection with proposed agency action. In establishing procedures, in this regard, the agencies have attempted to balance two competing interests. On the one hand, the agencies must carry out the mandate in the statute to act promptly to rectify problems at undercapitalized institutions in order to minimize the loss to the deposit insurance funds. On the other hand, the agencies believe that it is important to permit each affected institution or individual an adequate and fair opportunity to present arguments and information relevant to the agency's action. The agencies believe that they have struck a reasonable and workable balance that does not significantly compromise either interest.

Effect of Prompt Corrective Action

Turning to the impact of prompt corrective action, let me first address the much discussed question -- Will the implementation of prompt corrective action produce a December surprise? My short answer is, there will be no December surprise. As my colleague Governor LaWare testified on October 26th before the Senate Committee on Banking, Housing, and

Urban Affairs, a very small number of commercial banks will become subject to closure because they fall into the critically undercapitalized category. Based on the data from the June 30, 1992 regulatory reports and taking into account mergers and closures that have occurred between then and the end of last week, 34 commercial banks representing approximately $2.5 billion in assets fall into the critically undercapitalized category. These institutions have already been identified, and supervisors are closely monitoring their activities. Quite obviously, even if all of these banks ultimately become subject to closure, there will be no significant impact on the banking system or the resources of the deposit insurance fund. Moreover, the December 19th effective date for prompt corrective action has not caused a slowdown of the pace at which appropriate action is being taken against weak banking organizations.

I do not want to give the impression that the banking system is completely out of danger simply because only a small number of banks are critically undercapitalized. This single statistic does not present the whole picture. Data from the June, 1992 reports also indicate that 186 other commercial banks with about $55 billion in assets are either undercapitalized or significantly undercapitalized, and this number could be

expanded since, as you recall, prompt corrective action permits regulators to downgrade a bank by one capital category. Adding all three categories of undercapitalized institutions together, as of June 30, 1992, 1.9 percent of insured commercial banks, holding 1.7 percent of the industry's assets, fall into these categories.

In sum, a small number of banks will become subject to closure on December 19th when the prompt corrective action regulation becomes effective. A larger number of other troubled institutions that in the aggregate hold substantial assets will remain open but under close supervision. And so, it seems clear that the deposit insurance fund still has a significant loss exposure. It is important to recognize, however, that the fund has already set aside large loan loss reserves and will soon begin collecting higher deposit insurance premiums. At this point, there seems to be good reason to believe that the fund may be able to get by with little or no drawing upon its available emergency line with the Treasury.

Once we get beyond the initial phase of implementing prompt corrective action, and have dealt with those banks that are currently troubled, what will be the long-term effects of this framework? We believe it will be very positive. It will assure that supervisors address problems

more promptly and achieve earlier correction of those problems, and the very existence of such an array of mandatory and discretionary supervisory actions should work to discourage depository institutions from taking undue risks that can make them subject to the penalties of prompt corrective action.

Conclusion

To sum up, of the new supervisory measures contained in FDICIA, prompt corrective action is the most important. And the most significant aspect of prompt corrective action is the authority it grants supervisors to close institutions before they are actually book insolvent. Some of the other provisions of FDICIA support and reinforce the positive effects of prompt corrective action. Indeed, some of these provisions are particularly helpful -- for example, the requirement for annual examinations of depository institutions and the mandate to attempt to incorporate other risks into the measurement of capital.

I am afraid, however, that other provisions of FDICIA call for too much micromanagement of depository institutions by supervisors. This could unduly fetter institutions and, ultimately, could undermine their

profitability. It is important for the Congress to realize that one of the most significant actions it could take to contribute to the long-run viability of the banking industry would be to pass legislation to broaden the authority of banks to engage in other financial activities and to branch nationwide. Such authority would foster economies of scale and promote asset diversification and, thus, lead to an overall safer and sounder banking system. Yet another banking bill is needed to better balance FDICIA by easing overregulation and strengthening the industry with broader powers.

The most important benefit deriving from prompt corrective action will be stronger capital structures. The emphasis that it places on capital will induce many banks to strengthen their capital positions, and this will have a salutary effect on safeguarding the depository insurance fund and promoting stability in the banking system. But, beyond all of that, I think we should all remember that capital is its own reward. A strongly capitalized institution is better positioned to meet the challenges and exploit the opportunities of today's expanding financial services environment. It is a more attractive business counterparty. It can choose its own plan for growth through direct expansion or a strategy of carefully selected acquisitions. And, it can always deal from a position of strength. Last, but

not least, we should not forget the historical justification for strong capital -- the ability to wait out an economic downturn and to begin the upturn with a solid financial foundation.