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FDICIA's Prompt Corrective Action Provisions

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Following passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which addressed the insolvency of the Federal Savings and Loan Insurance Corporation's deposit insurance fund, policymakers turned their attention toward heading off a similar collapse of the Bank Insurance Fund (BIF). After months of wrangling, Congress forwarded the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) to the White House last November 27. As President Bush signed the bill into law a few weeks later, the BIF was roughly $7 billion in the red — its first deficit since the 1930s.

The purpose of FDICIA is twofold: to provide funding for federal deposit insurance and to reduce taxpayers' exposure to losses when depository institutions fail. Due to the deteriorating condition of the BIF, policymakers granted the FDIC an additional $30 billion in funding authority with little debate. The battle over *how* to limit taxpayer exposure was heated, however.

One way of reducing such exposure is by scaling back the financial safety net (that is, eliminating or reducing federal deposit insurance coverage). Congress has generally rejected this approach, seeking instead to limit taxpayer losses by improving the regulatory process. Specifically, FDICIA forces regulators to intervene earlier and more vigorously when a bank or thrift gets into trouble, and to close nonviable institutions promptly and at the least cost to uninsured depositors and the deposit insurance system.

This *Economic Commentary* focuses specifically on the early intervention (prompt corrective action) provisions in the bill. We review the origins of mandatory early intervention policy and the political economy arguments for supporting it, discuss the specific sections of the law that pertain to this policy, and offer a glance at how the new guidelines will impact the future of the nation's depositories.

The prompt corrective action provisions of last year's bill are simple common sense. They say, in effect: "Regulators, you should act earlier and more aggressively when a bank or thrift begins to get into trouble. Get in there, correct the problems, and turn the place around, if you can. And if you cannot, sell the place, or close it down, before it becomes a loss to the deposit insurance system and a liability to the American people."

Senator Donald W. Riegle, Jr.
Chairman, Senate Committee on Banking, Housing, and Urban Affairs[1]

■ Early Intervention and Regulatory Forbearance

Economists have long contended that prompt closure of depository institutions minimizes the losses to uninsured depositors and to the deposit insurance funds.[2] Prior to the 1980s, however, most assumed that bank regulators would act in the best interest of taxpayers by closing insolvent banks and thrifts in a timely fashion.

Professor Edward J. Kane was the first to challenge this assumption, arguing that a principal–agent conflict exists in public agencies. According to Kane, financial regulatory agencies are self-maximizing bureaucracies whose primary task may be conceived of as acting as the taxpayer's agent (the government's principal) by ensuring a safe and sound banking system, hence minimizing the public's exposure to loss. But at the same time, regulators must

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cater to a political clientele who may be thought of as intermediate or competing principals. Furthermore, regulators are sometimes motivated by their own self-interest, which may not coincide with the interests of taxpayers. These political pressures and self-interest considerations create socially perverse incentives that make forbearance an attractive alternative to early and forceful intervention in troubled institutions.[3]

Mandatory prompt intervention is one way to provide regulators with the proper incentives to close nonviable depositories. FDICIA's prompt intervention provisions are similar to those proposed in 1988 by economists George Benston and George Kaufman, who saw early intervention as a practical way of altering depositories' incentive structure and allocating scarce regulatory resources.[4]

Benston and Kaufman contend that the advantages of such a policy would accrue on four fronts: First, reducing the regulatory burden on sound, well-capitalized institutions would enhance the efficiency of the financial sector. Second, stepping up regulatory interference on deteriorating firms would mitigate the risk-taking incentives embedded in deposit insurance by imposing more market discipline. Third, linking regulatory response directly to an institution's financial condition would end misguided regulatory forbearance policies such as the "too big to let fail" doctrine.[5] Finally, forcing regulators to close an institution at or near the point of insolvency would reduce the cost to uninsured depositors and to the federal deposit insurance system.[6]

The escalating costs of closing insolvent thrifts due to capital forbearance, combined with the BIF's mounting losses, motivated legislators to strip away a large degree of discretion from bank and thrift regulators.[7] Lawmakers first incorporated the notion of prompt intervention in the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1990. The Treasury Department later included a similar recommendation in its reform proposal of February 1991, which became the basis for the Senate and House bills ultimately signed into law by President Bush last December.[8]

BOX 1 FDICIA CAPITAL CATEGORIES FOR INSURED DEPOSITORIES

Group 1	Well capitalized	Significantly exceeds the required minimum level for each relevant capital measure
Group 2	Adequately capitalized	Meets the required minimum level for each relevant capital measure
Group 3	Undercapitalized	Fails to meet the required minimum for any relevant capital measure
Group 4	Significantly undercapitalized	Falls significantly below the required minimum for any relevant capital measure
Group 5	Critically undercapitalized	Fails to meet any specified capital measure

Several researchers have shown that the capital forbearance policies adopted in response to the insolvency of the Federal Savings and Loan Insurance Corporation significantly increased the losses now being borne by taxpayers. One study notes that for savings institutions closed from 1980 through 1988, the most important factor in determining resolution costs was the number of months the firm remained tangibly insolvent.[9] Another estimates that for savings and loans closed from 1980 through 1990, or projected to be closed in the future, final resolution costs will be $66 billion higher (in 1990 dollars, excluding interest costs) because of delayed intervention.[10] And work done at the Federal Reserve Bank of Cleveland shows that regulators' failure to take prompt corrective action against the thrifts that did not meet capital standards at the end of 1979 caused an increase in direct real resolution costs of more than *200 percent*.[11] Other analysts have reached similar conclusions concerning the resolution costs of troubled commercial banks.[12]

■ FDICIA's Prompt Corrective Action Provisions

Armed with such information, policymakers devised FDICIA to restrict regulatory discretion, effectively ending the long-standing practice of capital forbearance. Regulators still exercise considerable control in setting capital standards, but their flexibility in applying those standards has been curtailed.

Specifically, FDICIA requires regulators to step up their level of involvement according to an institution's capital rating, which in essence means fewer options for dealing with the most troubled firms. The new legislation expands the scope of regulatory action while mandating a minimum regulatory response time.

FDICIA ties the extent of regulatory involvement directly to depositories' capital levels, which are divided into five categories (see box 1): well capitalized (Group 1), adequately capitalized (Group 2), undercapitalized (Group 3), significantly undercapitalized (Group 4), and critically undercapitalized (Group 5).[13] Each federal banking agency must determine the required minimum levels for all five classifications. These standards must include a leverage limit (a measure of core capital) and a risk-based capital level. However, the law does authorize agencies to enact new minimum requirements or to abolish the leverage and risk-based ratios with the consent of other agencies.

The only specified common standard concerns the minimum leveraging for any Group 5 (critically undercapitalized) institution. In this case, each agency must establish a level of tangible net worth that is no less than 2 percent of total assets and no greater than 65 percent of the required leverage limit. Furthermore, no institution may make a

capital distribution or pay a management fee that would cause it to become undercapitalized.

The new guidelines prescribe a specific course of action for regulators to follow when intervening in all three types of undercapitalized institutions. Once an institution becomes undercapitalized (Group 3), it is given 45 days to submit a capital restoration plan to the appropriate agency, which then has 60 days to respond. The plan should specify the company's recovery strategy, its targeted capital levels, and its ability to abide by regulations, and must be approved by the governing agency. Otherwise, the firm will descend into Group 4.[14] A Group 3 institution also must restrict asset growth and obtain regulatory approval before acquiring other entities, opening new branches, or developing new lines of business.

FDICIA strips regulators of much of their supervisory discretion over significantly undercapitalized (Group 4) depositories as well. By law, such institutions must, if possible, 1) sell enough shares of stock or subordinated debt to become adequately capitalized, 2) merge with or be bought by another institution if grounds exist for appointing a conservator or receiver, 3) restrict transactions with sister banks, and 4) restrict interest rates paid on deposits. Regulatory agencies retain some discretion in imposing other penalties, which can include restricting asset growth, changing or ending certain bank activities, and firing directors and senior executive officers.[15]

Regulators have even less latitude in dealing with critically undercapitalized (Group 5) institutions. The appropriate agency must appoint a receiver or conservator for such firms within 90 days, unless that agency and the FDIC decide that prompt corrective action would be better served by other means. Institutions cannot make any interest or capital payments on their subordinated debt beginning 60 days after being designated critically undercapitalized. Furthermore, regulators can prohibit Group 5 entities from opening new lines of business, engaging in covered or highly leveraged transactions, making excessive compensation or bonus payments, paying interest on new or renewed liabilities, altering accounting methods, or amending bylaws and charters.[16]

BOX 2 PRIMARY SUPERVISORS OF BANKS AND THRIFTS

Institution	Regulator
National banks	Office of the Comptroller of the Currency
State member banks	Federal Reserve and state authority
Insured nonmember banks	FDIC and state authority
Noninsured banks	State authority[a]
Insured federal savings associations	Office of Thrift Supervision
Insured state savings associations	Office of Thrift Supervision and state authority
Uninsured state savings associations	State authority[a]
Federal credit unions	National Credit Union Association Board
State credit unions	State authority
Bank holding companies	Federal Reserve
Savings and loan holding companies	Office of Thrift Supervision

a. The FDIC can intervene in the administration of these institutions to prevent a loss to the federal deposit insurance fund.
NOTE: The FDIC has some examination authority over all FDIC-insured institutions.

The Short-Run Impact of Prompt Intervention

FDICIA requires regulators to establish the exact capital levels for determining prompt intervention (see box 2). The Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency have proposed criteria for these levels. At press time, however, the proposal was still out for public comment and had not been officially adopted. Although the formal definitions may vary from the current recommendations, the differences will likely be minimal.

Using the proposed standards, table 1 presents a breakdown of depository institutions by capital category and asset size. Based on March 31, 1992 data, 91.6 percent of all banks, 82.6 percent of all mutual savings banks, and 65.9 percent of all savings and loans would be categorized as well capitalized. At the same time, another 5.9 percent of banks, 13.4 percent of mutual savings banks, and 17.7 percent of savings and loans would be categorized as adequately capitalized.

Insufficiently capitalized institutions (Groups 3, 4, and 5) would account for 2.6 percent of all commercial banks and 6.2 percent of commercial bank assets. Among mutual savings banks, insufficiently capitalized institutions would compose 4.0 percent of the sample, but only 0.8 percent of industry assets. For savings and loans, the numbers are bleaker: 16.4 percent of these firms and a staggering 26.4 percent of their assets would fall into the lowest three classifications.[17] In total, 654 depository institutions holding $450.2 billion in assets would be subject to prompt corrective action under the proposed guidelines.

Panel A of the table highlights an inverse relationship between capital ratios and problem loans and thus provides a rationale for prompt intervention based on capital health. For well-capitalized commercial banks, Tier 1 capital (primarily equity) made up 7.85 percent of total assets, while problem loans constituted only 2.59 percent. Adequately capitalized commercial banks had nearly 50 percent more problem loans as a percentage of assets (3.82 percent) and held 31.34 percent

TABLE 1 INDUSTRY COMPOSITION UNDER PROPOSED CAPITAL GUIDELINES (AS OF MARCH 31, 1992)

	Well Capitalized (Group 1)	Adequately Capitalized (Group 2)	Undercapitalized (Group 3)	Significantly Undercapitalized (Group 4)	Critically Undercapitalized (Group 5)	Total
Panel A: Commercial Banks						
Number of depositories	10,422	673	183	43	65	11,406
Percent of total industry	91.55	5.90	1.60	0.38	0.57	
Total assets	$1,674,031	$1,475,571	$187,243	$10,845	$9,908	$3,357,599
Percent of industry assets	49.86	43.95	5.58	0.32	0.30	
Problem loans	$43,311	$56,359	$11,854	$456	$1,056	$113,037
Percent of total assets	2.59	3.82	6.33	4.20	10.66	3.37
Tier 1 capital	$131,428	$79,469	$8,553	$312	$47	$219,809
Percent of total assets	7.85	5.39	4.57	2.87	0.47	6.55
Panel B: Mutual Savings Banks						
Number of depositories	390	63	14	1	4	472
Percent of total industry	82.63	13.35	2.97	0.21	0.85	
Total assets	$154,774	$206,549	$1,755	$59	$914	$364,051
Percent of industry assets	42.51	56.74	0.48	0.02	0.25	
Problem loans	$5,460	$9,407	$99	$5	$114	$15,084
Percent of total assets	3.53	4.55	5.65	7.82	12.45	4.14
Tier 1 capital	$12,354	$10,954	$84	$2	$12	$23,405
Percent of total assets	7.98	5.30	4.76	2.85	1.31	6.43
Panel C: Savings and Loans						
Number of depositories	1,384	371	153	74	117	2,099
Percent of total industry	65.94	17.68	7.29	3.53	5.57	
Total assets	$424,871	$244,036	$114,433	$44,774	$80,233	$908,347
Percent of industry assets	46.77	26.87	12.60	4.93	8.83	
Problem loans	$15,353	$11,917	$7,362	$3,863	$11,313	$49,808
Percent of total assets	3.61	4.88	6.43	8.63	14.10	5.48
Tier 1 capital	$32,045	$11,673	$4,477	$1,156	–$1,980	$47,372
Percent of total assets	7.54	4.78	3.91	2.58	–2.47	5.22

NOTE: All dollar figures are in millions.
SOURCE: Board of Governors of the Federal Reserve System.

less capital than their well-capitalized peers. For undercapitalized commercial banks, the ratio of problem loans to assets was nearly double that of adequately capitalized banks, and these institutions had roughly 15 percent less capital than their adequately capitalized counterparts. Moreover, problem loans *exceeded* Tier 1 capital for banks in all of the insufficiently capitalized categories, and with the exception of significantly undercapitalized banks, they increased as capital decreased. A similar negative relationship between capitalization and problem assets was exhibited by mutual savings banks and savings and loans.

One should not consider these data a definitive description of the health of the U.S. depository industry. For example, while only 291 banks with $208 billion in assets would be classified as insufficiently capitalized and hence subject to mandatory intervention, the FDIC problem bank list contains 981 institutions with a total of $535.4 billion in assets.[18] The FDIC has also targeted 70 mutual savings banks with $72 billion in assets, even though only 19 such firms with $3.2 billion in assets would be considered insufficiently capitalized under the proposed guidelines.

In other words, the prompt corrective action classifications require further modification, since they appear to pick up only the most severely undercapitalized institutions. A recent study by staff

economists at the Federal Reserve Board of Governors concludes that "...without substantial improvements in the measurement of capital ratios (especially in the treatment of loan loss reserves and other real estate owned), prompt corrective action policies will not effectively target high-risk banks for sanctions without continued heavy reliance on discretionary interventions by regulators."[19]

Still, the problem loan and Tier 1 capital numbers presented here do provide some valuable insight. For instance, those institutions that fall into the critically undercapitalized group have little realistic chance of recovering. In this stratum, commercial banks and mutual savings banks held problem loans equal to 20 times and 10 times Tier 1 capital, respectively, while savings and loans had problem assets equal to 14.1 percent of total assets and *negative* Tier 1 capital. Furthermore, it is apparent that significantly undercapitalized institutions will probably not recover without a substantial capital injection.

The table also suggests that FDICIA's prompt corrective action provisions are unlikely to disrupt the nation's financial system. While the potential number of firms and assets directly affected by such intervention seems large, it represents only a small fraction of the industry and industry assets. Moreover, those institutions subject to the most severe regulatory actions, including closure, are the ones that have little hope of recovering and that pose the greatest risk to the deposit insurance system.

■ Conclusion

The prompt corrective action provisions in FDICIA represent a small step toward limiting taxpayers' losses when depository institutions fail. As Senior Counsel of the Senate Committee on Banking, Housing, and Urban Affairs Richard Carnell states, "[FDICIA] neither ended nor sought to end regulatory discretion in supervising depository institutions."[20] Rather, it clearly spells out Congressional intent in regard to bank regulation without dictating microregulatory decisions. Though the number of capital categories and certain regulatory actions are now mandated by law, regulators retain the authority to determine capital levels and, to some extent, the course of intervention.

Under the currently proposed definitions, 654 depository institutions holding $450.2 billion in assets would have been subject to some form of corrective action as of March 31, 1992. However, they represent a small percentage of the industry and a subset of the total number of institutions considered by regulators to be in danger of failing.

Thus, prompt corrective action is simply a first step toward eliminating regulatory forbearance and its attendant perverse incentives for insured financial institutions. By forcing more timely closure or reorganization on sick depositories, the burden imposed on the deposit insurance fund, and ultimately on taxpayers, will diminish.

■ Footnotes

1. See Senator Donald W. Riegle, Jr., "Statement on the President's Proposed Credit Availability and Regulatory Relief Act of 1992," *Congressional Record* (daily edition), July 27, 1992, p. S10386.

2. See Stephen A. Buser, Andrew H. Chen, and Edward J. Kane, "Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital," *Journal of Finance*, vol. 36 (March 1981), pp. 51–60.

3. See Edward J. Kane, *The S&L Insurance Mess: How Did It Happen?* Washington, D.C.: The Urban Institute Press, 1989; "Changing Incentives Facing Financial-Services Regulators," *Journal of Financial Services Research*, vol. 2 (August 1989), pp. 265–74; and "Principal–Agent Problems in S&L Salvage," *Journal of Finance*, vol. 45 (July 1990), pp. 755–64. See also Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics*, vol. 3 (October 1976), pp. 305–60.

4. See George J. Benston and George G. Kaufman, "Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Options," Federal Reserve Bank of Chicago, Staff Memorandum, 1988.

5. See James B. Thomson and Walker F. Todd, "An Insider's View of the Political Economy of the Too Big to Let Fail Doctrine," *Public Budgeting and Financial Management*, vol. 3 (1991), pp. 547–617.

6. For a thorough discussion of why regulators delay closing firms, see Edward J. Kane, "Appearance and Reality in Deposit Insurance Reform: The Case for Reform," *Journal of Banking and Finance*, vol. 10 (June 1986), pp. 175–88; and James B. Thomson, "Modeling the Bank Regulator's Closure Option: A Two-Step Logit Regression Approach," *Journal of Financial Services Research*, vol. 6 (May 1992), pp. 5–23.

7. For an analysis of the evolution of the thrift crisis and capital forbearance policies, see James R. Barth, *The Great Savings and Loan Debacle*. Washington, D.C.: American Enterprise Institute, 1991; Edward J. Kane, *The S&L Insurance Mess: How Did It Happen?* (see footnote 3); and Lawrence J. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation*. New York: Oxford University Press, 1991.

8. On February 5, 1991, the Treasury Department submitted to Congress a report entitled "Modernizing the Financial System: Recommendations for Safer, More Competitive Banks," which set forth the Administration's proposals for modernizing the industry. The Treasury then followed with a legislative package on March 20 (H.R. 1505 and S. 713), The Financial Institutions Safety and Consumer Choice Act of 1991. The House failed to pass both H.R. 1505 and two narrower versions (H.R. 6 and H.R. 2094), but eventually succeeded on a fourth version, passing H.R. 3768 on November 21. Meanwhile, the Senate worked on its own bill, S. 543, which closely resembled H.R. 3768, but was broader in scope. Eventually, the House and Senate worked out their differences and forwarded The FDIC Improvement Act of 1991 (S. 543) to President Bush on November 27, 1991.

9. See James R. Barth, Philip F. Bartholomew, and Michael G. Bradley, "Determinants of Thrift Institution Resolution Costs," *Journal of Finance*, vol. 45 (July 1990), pp. 731–54.

10. See Philip F. Bartholomew, "The Cost of Forbearance during the Thrift Crisis," Congressional Budget Office, CBO Staff Memorandum, June 1991.

11. See Ramon P. DeGennaro and James B. Thomson, "Capital Forbearance and Thrifts: An Ex Post Examination of Regulatory Gambling," Federal Reserve Bank of Cleveland, Working Paper 9209, September 1992.

12. See James R. Barth, R. Dan Brumbaugh, Jr., and Robert E. Litan, *The Future of American Banking*, Armonk, N.Y.: M. E. Sharpe, Inc., 1992.

13. See FDIC Improvement Act of 1991, P.L. No. 102–242, 105 Stat. 2253 (1991).

14. An institution can also fall under Group 4 scrutiny if it is unable to implement or even to submit an acceptable capital restoration plan within the established time frame.

15. See footnote 13, Stat. 2258–61.

16. Ibid., Stat. 2261–63.

17. This includes the 60 thrifts with $23.2 billion in assets operating in Resolution Trust Corporation conservatorship as of June 30, 1992. See *RTC Review*, vol. 3 (August 1992), p. 2.

18. See *The FDIC Quarterly Banking Profile* (First Quarter 1992), p. 11.

19. See David S. Jones and Kathleen Kuester King, "The Implementation of Prompt Corrective Action," *Proceedings of a Conference on Bank Structure*, Federal Reserve Bank of Chicago (forthcoming).

20. See Richard Scott Carnell, "The FDIC Improvement Act of 1991: Improving Incentives of Depository Institutions' Owners, Managers, and Regulators," unpublished manuscript, August 1992.

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