FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10584**
October 14, 1992]

PROMPT CORRECTIVE ACTION FOR UNDERCAPITALIZED INSTITUTIONS

Amendments to Regulation H and Rules of Practice for Hearings

Effective December 19, 1992

To All State Member Banks, and Bank Holding Companies, in the Second Federal Reserve District:

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued a final rule to carry out the "Prompt Corrective Action" provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (Section 131). The rule applies to State member banks and goes into effect on December 19, 1992.

The Board adopted this rule following the receipt of public comment and in consultation with the other Federal banking agencies. The rules adopted by each agency are substantially the same.

Section 131 created a legal framework for a system of supervisory actions based primarily on the capital levels of individual institutions. The purpose of the provision is to resolve the problems of insured institutions at the least possible long-term loss to the deposit insurance fund.

The regulation adopted by the Board:

— Defines capital measures and the capital thresholds for each of the five categories established in the law.

— Establishes a uniform schedule for filing of capital restoration plans by undercapitalized institutions and agency review of those plans.

— Clarifies aspects of the capital guarantees made as part of an acceptable capital plan by companies that control an undercapitalized institution.

— Establishes procedures for providing institutions with advance notice of a proposed supervisory directive and an opportunity to contest the directive.

— Establishes procedures for reclassifying an institution to a lower capital category based on supervisory factors other than capital.

— Establishes procedures by which officers and directors who are dismissed as a result of an agency order may obtain review of the dismissal and possible reinstatement.

(OVER)

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Enclosed, for State member banks, bank holding companies, and those who maintain sets of the Board's regulations, is an excerpt from the *Federal Register* of September 29, containing the official notice of this action by the Federal regulatory agencies, together with the text of the amendments to the Board's Regulation H, "Membership of State Banking Institutions in the Federal Reserve System," and to its Rules of Practice for Hearings, effective December 19, 1992; the implementing regulations of the other agencies, also published in that issue of the *Federal Register*, have not been reprinted by us. Additional, single copies of the enclosure can be obtained at this Bank (33 Liberty Street) from the Issues Division on the first floor, or by calling our Circulars Division (Tel. No. 212-720-5215 or 5216).

Questions on this matter may be directed to Beverly J. Hirtle, Manager of our Banking Studies Department (Tel. No. 212-720-7544).

E. GERALD CORRIGAN,
President.

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federal register

Tuesday
September 29, 1992

Part IV

Department of the Treasury

Office of the Comptroller of the Currency
12 CFR Parts 6 and 19
Office of Thrift Supervision
12 CFR Part 565
Prompt Corrective Action; Rules of Practice for Hearings; Final Rules

Federal Reserve System

12 CFR Parts 208 and 263

Federal Deposit Insurance Corporation

12 CFR Parts 308 and 325

[Enc. Cir. No. 10584]

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DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Parts 6 and 19

[Docket No. 92-19]

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 263

[Docket No. R-0763; Regulation H]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Parts 308 and 325

RIN 3064-AB16

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 565

[Resolution No. 92-403]

RIN 1550-AA57

Prompt Corrective Action; Rules of Practice for Hearings

AGENCIES: Board of Governors of the Federal Reserve System; Office of the Comptroller of the Currency, Treasury; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Final rules.

SUMMARY: The Board of Governors of the Federal Reserve System (Board of Governors), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively "the agencies") have adopted final rules revising their regulations to implement for the institutions that they supervise the system of prompt corrective action established by section 38 of the Federal Deposit Insurance Act (FDI Act) as added by section 131 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Section 38 requires each Federal banking agency to implement prompt corrective action for the institutions that it regulates. The agencies have also revised their rules of practice for hearings to establish procedures for the issuance of directives and other actions required under prompt corrective action.

Section 38 requires or permits the agencies to take certain supervisory actions when an insured depository institution falls within one of five specifically enumerated capital categories. It also restricts or prohibits certain activities and requires the submission of a capital restoration plan when an insured institution becomes undercapitalized. The revisions adopted by the agencies are necessary to establish the capital levels at which institutions will be deemed to come within the five capital categories. The revisions also establish procedures for issuing and contesting prompt corrective action directives including directives requiring the dismissal of directors and senior executive officers.

The agencies sought public comment on this proposal in July 1992. The final rule reflects a number of changes to the original proposal to address concerns raised by the commenters.

EFFECTIVE DATE: December 19, 1992.

FOR FURTHER INFORMATION CONTACT:

Federal Reserve Board: Frederick M. Struble, Associate Director (202/452-3794), Norah Barger, Supervisory Financial Analyst (202/452-2402), Division of Banking Supervision and Regulation; Scott G. Alvarez, Associate General Counsel (202/452-3583), Gregory A. Baer, Senior Attorney (202/452-3236), Legal Division; Myron L. Kwast, Assistant Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

OTS: John Connolly, Program Manager, (202) 906-6465, Policy; Lorraine E. Waller, Counsel (Banking and Finance), (202) 906-6457, Deborah Dakin, Assistant Chief Counsel, (202) 906-6445, Regulations and Legislation Division, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

FDIC: Daniel M. Gautsch, Examination Specialist (202-898-6912), Stephen G. Pfeifer, Examination Specialist (202-898-8904), Division of Supervision; Valerie Jean Best, Counsel (202-898-3812), Claude A. Rollin, Counsel (202-898-3985), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

OCC: Kevin J. Bailey, Executive Assistant, Senior Deputy Comptroller for Bank Supervision Operations, (202) 874-5030; Daniel Berkland, National Bank Examiner, Special Supervision, (202) 874-4450; or Beth Kirby, Senior Attorney, Corporate Organization and Resolutions Division, (202) 874-5300, Office of Comptroller of the Currency.

SUPPLEMENTARY INFORMATION:

I. Background

In early July, the Board of Governors of the Federal Reserve System (Federal Reserve Board) (57 FR 29226, July 1, 1992), the Federal Deposit Insurance Corporation (FDIC) (57 FR 29662, July 6, 1992), the Office of the Comptroller of the Currency (OCC) (57 FR 29808, July 7, 1992), and the Office of Thrift Supervision (OTS) (57 FR 29826, July 7, 1992) proposed regulations to implement the provisions of section 131 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) (Pub. L. 102-242), which is entitled "Prompt Corrective Action". Section 131 of FDICIA created a new statutory framework that applies to every insured depository institution a system of supervisory actions indexed to the capital level of the individual institution. The stated purpose of this statutory provision is to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund. The new framework is contained in section 38 of the FDI Act (12 U.S.C. 1831o) ("section 38"). This framework and the authority it confers on the Federal banking agencies are meant to supplement the existing supervisory authority vested in the agencies, and do not limit in any way the agencies' existing authority under other statutes or regulations to initiate supervisory actions to address capital deficiencies, unsafe or unsound conduct, practices, or conditions, or violations of law.

Section 38 requires the Federal banking agencies, within 9 months of the enactment of FDICIA, to promulgate final regulations necessary to carry out the purposes of that section. Under the statute, these regulations must become effective within one year after the date of enactment of FDICIA, or no later than December 19, 1992.

II. Summary of Final Rules

The agencies have received 92 comments from interested persons, and have reviewed the original proposal in light of those comments. As an initial matter, the commenters strongly supported the agencies' efforts to adopt uniform rules implementing the provisions of section 38. The agencies believe that a uniform approach to capital definitions and capital categories, as well as a uniform framework of procedures, will simplify the tasks facing bank and thrift management of monitoring and maintaining the capital levels of insured depository institutions, and will remove any competitive distortions that might

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arise if different standards were applied to competing institutions. Accordingly, the agencies have adopted substantially the same rules.

The final rules that have been adopted by the agencies are substantially as originally proposed by the agencies, with modifications to address concerns and issues raised by the commenters. In particular, the final rules define the relevant capital measures for the categories of well-capitalized, adequately capitalized, undercapitalized, and significantly undercapitalized, to be the ratio of total capital to risk-weighted assets, the ratio of Tier 1 capital to risk-weighted assets, and the ratio of Tier 1 capital to total average assets (the leverage ratio).[1] The ratio of tangible equity to total assets has been adopted as the sole relevant capital measure for defining the critically undercapitalized category.

The capital thresholds that have been adopted for each of the five capital categories are the thresholds that were originally proposed by the agencies. Under the final rules, an institution will be deemed to be:

• *Well-capitalized* if the institution has a total risk-based capital ratio of 10.0 percent or greater, a Tier 1 risk-based capital ratio of 6.0 percent or greater, and a leverage ratio of 5.0 percent or greater, and the institution is not subject to an order, written agreement, capital directive, or prompt corrective action directive to meet and maintain a specific capital level for any capital measure;

• *Adequately capitalized* if the institution has a total risk-based capital ratio of 8.0 percent or greater, a Tier 1 risk-based capital ratio of 4.0 percent or greater, and a leverage ratio of 4.0 percent or greater (or a leverage ratio of 3.0 percent or greater if the institution is rated composite 1 in its most recent report of examination, subject to appropriate Federal banking agency guidelines), and the institution does not meet the definition of a well-capitalized institution;

• Undercapitalized if the institution has a total risk-based capital ratio that is less than 8.0 percent, a Tier 1 risk-based capital ratio that is less than 4.0 percent, or a leverage ratio that is less than 4.0 percent (or a leverage ratio that is less than 3.0 percent if the institution is rated composite 1 in its most recent report of examination, subject to appropriate Federal banking agency guidelines);

• Significantly undercapitalized if the institution has a total risk-based capital ratio that is less than 6.0 percent, a Tier 1 risk-based capital ratio that is less than 3.0 percent, or a leverage ratio that is less than 3.0 percent.

• Critically undercapitalized if the institution has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent.

To the extent possible, the final rules define capital terms in the same way as they are defined under existing capital adequacy standards. The final rules also generally rely on the most recent Consolidated Report of Condition and Income (Call Report) [2] and examination report for determining the capital category of an institution, and provide that the appropriate banking agency will provide written notice to an institution in the event that the agency determines the capital category of the institution on the basis of other information. The final rules also establish a procedure for an institution to notify the appropriate agency in the event that a material event occurs that would result in the reclassification of the institution to a lower capital category. This procedure has been modified in several respects to address concerns raised by commenters. The final rules do not adopt a requirement that an institution calculate its capital position on a daily basis.

The final rules establish a uniform schedule for filing and reviewing capital restoration plans. In addition, the rules adopt several provisions clarifying certain aspects of the capital guarantee required to be made as part of an acceptable capital plan by companies that control an undercapitalized institution, including the limit on the liability of such companies.

The agencies have adopted uniform procedures for the issuance of directives by the appropriate agency under section 38. Under these procedures, an institution will generally be provided advance notice when the appropriate agency proposes that the institution take one or more of the actions committed to agency discretion under section 38. These procedures provide an opportunity for the institution to respond to the proposed agency action, or, where circumstances warrant immediate agency action, an opportunity for administrative review of the agency's action.

A separate procedure has been adopted in the case of proposals by the appropriate Federal banking agency to subject an institution to more stringent treatment based on supervisory factors other than capital. The proposed procedures were modified at the request of commenters to provide an informal hearing whether the treatment is based on a determination that the institution is in unsafe or unsound condition or based on an institution's failure to correct deficient ratings received in an examination. The final rules also implement the statutory requirement that officers and directors dismissed as a result of an agency order issued under section 38 be afforded agency review of the dismissal, including an opportunity for an informal hearing.

The final rules and the public comments are discussed in more detail below.

III. Summary of Statutory Framework

In the request for comment, the agencies provided a brief summary of the statutory framework established by section 38. That summary is reprinted here in order to give context to the agencies' final rules. The summary is not intended to be a complete description of the requirements of section 38, and insured institutions and other persons affected by section 38 should consult the provisions of section 38.

Section 38 provides a framework of supervisory actions based on the capital level of an insured depository institution. Section 38 establishes five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The statute deems an insured depository institution to be:

> "Well capitalized" if the institution significantly exceeds the required minimum level for each relevant capital measure;
> "Adequately capitalized" if the institution meets the required minimum level for each relevant capital measure;
> "Undercapitalized" if the institution fails to meet the required minimum level for any relevant capital measure;
> "Significantly undercapitalized" if the institution is significantly below the required minimum level for any relevant capital measure; or,
> "Critically undercapitalized" if the institution has a ratio of tangible equity to total assets of 2 percent or less, or otherwise fails to meet the critical capital level established pursuant to section 38 (c)(3)(A).

Section 38 requires the Federal banking agencies to specify, by regulation, the levels at which an institution would be within each of these five categories. The applicability

[1] For savings associations, all references to Tier 1 capital should be read as core capital, as defined in part 567 of the OTS's regulations, which is the thrift capital measure comparable to Tier 1 capital. 12 CFR part 567. In addition, all references to total average assets should be read as adjusted total assets, as defined in part 567 of the OTS's regulations.

[2] Savings associations report their capital levels on Thrift Financial Reports.

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of supervisory actions provided in section 38 to an individual institution depends on the institution's classification within one of these five categories.[3]

A. Provisions Applicable to All Institutions

Section 38 prohibits an insured depository institution from declaring any dividends, making any other capital distribution, or paying a management fee to a controlling person if, following the distribution or payment, the institution would be within any of the three undercapitalized categories.[4] The statute provides a limited exception to this prohibition for stock redemptions that do not result in any decrease in an institution's capital and would improve the institution's financial condition, provided that the redemption has been approved by the institution's appropriate Federal banking agency after consultation with the FDIC.

B. Provisions Applicable to Undercapitalized Institutions

Institutions that are classified as undercapitalized are subject to additional mandatory supervisory actions. These include:

- Increased monitoring by the appropriate Federal banking agency for the institution and periodic review of the institution's efforts to restore its capital;
- A requirement that the institution submit, generally within 45 days, a capital restoration plan acceptable to the appropriate Federal banking agency for the institution and implement that plan;
- A restriction on growth of the institution's total assets; and
- A limitation on the institution's ability to make any acquisition, open any new branch offices, or engage in any new line of business without the prior approval of the appropriate Federal banking agency for the institution or the FDIC.

Section 38 also provides that the appropriate Federal banking agency for an undercapitalized institution may take any of a number of discretionary supervisory actions if the agency determines that any of these actions is necessary to resolve the problems of the institution at the least possible long-term cost to the deposit insurance fund. These discretionary supervisory actions include requiring the institution to raise additional capital, restricting transactions with affiliates, restricting interest rates paid by the institution on deposits, requiring replacement of senior executive officers and directors, restricting the activities of the institution and its affiliates, requiring divestiture of the institution or the sale of the institution to a willing purchaser, and any other supervisory action that the agency believes would better carry out the purpose of section 38. Because these discretionary actions are also applicable to significantly undercapitalized institutions (as well as to critically undercapitalized institutions), these actions are described more fully in the next section.

C. Provisions Applicable to Significantly Undercapitalized Institutions

Section 38 provides that significantly undercapitalized institutions are subject to the four mandatory provisions listed above that are applicable to undercapitalized institutions. Section 38 also restricts the ability of a significantly undercapitalized institution to pay bonuses or raises to senior executive officers of the institution. A significantly undercapitalized institution may pay bonuses and raises to senior executive officers of the institution with the prior written approval of the appropriate Federal banking agency, unless the institution has failed to submit an acceptable capital restoration plan. For so long as an institution has failed to submit an acceptable capital restoration plan, the institution is prohibited from paying any bonus or raise to any senior executive officer.

In addition to these mandatory requirements, section 38 specifies that the appropriate Federal banking agency shall impose one or more restrictions on an institution that is significantly undercapitalized. These discretionary actions include:

- Requiring the institution to sell enough additional capital, including voting shares, so that the institution would be adequately capitalized after the sale;
- Restricting transactions between the institution and its affiliates, including transactions with its insured depository institution affiliates;
- Restricting the interest rates paid on deposits collected by the institution to the prevailing rates in the region where the institution is located;
- Restricting the institution's asset growth or requiring the institution to reduce its total assets;
- Requiring the institution or any subsidiary of the institution to terminate, reduce or alter any activity that the agency determines poses excessive risk to the institution;
- Requiring the institution to hold a new election of its board of directors;
- Requiring the institution to dismiss any director or senior executive officer who had held office at the institution for more than 180 days immediately before the institution became undercapitalized if the agency deems such dismissal to be appropriate, and to employ new officers who may be subject to agency approval;
- Prohibiting the institution from accepting deposits from correspondent depository institutions;
- Prohibiting any bank holding company that controls the institution from making any dividend payment without prior approval of the Federal Reserve Board;
- Requiring the institution to accept an offer to be acquired by another institution or company, or requiring any company that controls the institution to divest the institution;
- Requiring the institution to divest or liquidate any subsidiary that is in danger of becoming insolvent and poses a significant risk to the institution, or that is likely to cause significant dissipation of the institution's assets or earnings;
- Requiring any company that controls the institution to divest or liquidate any affiliate of the institution (other than another insured depository institution) if the appropriate Federal banking agency for the holding company determines that the affiliate is in danger of becoming insolvent and poses a significant risk to the institution, or is likely to cause significant dissipation of the institution's assets or earnings; and
- Requiring the institution to take any other action that the agency determines would better carry out the purposes of section 38.

While the statute generally provides the agency with discretion to determine whether these actions are appropriate in connection with a particular institution, the statute establishes certain presumptions and requirements with respect to the agency's consideration of these actions. Section 38 requires that the appropriate agency take at least one of the above discretionary supervisory actions in connection with an institution that is significantly undercapitalized or critically undercapitalized. The statute also establishes a presumption that the agency require each significantly undercapitalized or critically undercapitalized institution to (1) be acquired by another institution or company or sell sufficient shares to restore the institution's capital to at least the minimum acceptable capital

[3] A savings association operating in accordance with a capital plan approved by the OTS before December 19, 1991, is subject to certain exceptions from provisions of section 38 (12 U.S.C. 1831o(o)(2)). However, neither section 38 nor this regulation in any way limits the authority of the OTS under any other provision of law to take supervisory actions to address unsafe or unsound practices, deficient capital levels, violations of law or regulation, unsafe or unsound conditions or other practices.

[4] The OTS intends that the permissibility of capital distributions will be determined by the prompt corrective action regulations. A savings association permitted to make a capital distribution under the prompt corrective action regulations may do so if the amount and type of distribution would be permitted under section 563.134 of the OTS's regulations. The OTS will review its capital distributions regulations and consider making amendments that may be necessary based on section 38 of the FDI Act.

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level, (2) restrict transactions with affiliates of the institution, including transactions with depository institution affiliates, and (3) restrict the interest rates the institution pays on deposits. The agency must impose each of these three actions unless the agency determines that the action would not further the purpose of section 38.

As discussed above, each of the discretionary actions listed above may also be taken, by issuance of a prompt corrective action directive, in connection with undercapitalized institutions if a finding is made by the agency that the action is necessary to carry out the purposes of section 38. In addition, these discretionary actions may be taken in connection with any undercapitalized institution that fails to submit or implement in any material respect a capital restoration plan, as if the institution were a significantly undercapitalized institution. As noted above, the provision restricting the payment of bonuses and raises to senior executive officers applies to any undercapitalized institution that has failed to submit a capital restoration plan that is acceptable to the appropriate agency.

In addition to the discretionary actions discussed above, section 38 also provides that, where the appropriate agency finds it necessary to carry out the purposes of section 38, the agency may require, by issuance of a prompt corrective action directive, a significantly undercapitalized institution to comply with one or more of the restrictions established by the FDIC on the activities of critically undercapitalized institutions. The same actions may be taken in the case of an undercapitalized institution that has failed to submit or implement, in any material respect, an acceptable capital restoration plan.

D. Provisions Applicable to Critically Undercapitalized Institutions

Section 38 requires that an insured depository institution that is critically undercapitalized be placed in conservatorship (with the concurrence of the FDIC) or receivership within 90 days, unless the appropriate Federal banking agency for the institution and the FDIC concur that other action would better achieve the purposes of section 38. A determination by the agency to defer placing a critically undercapitalized institution in receivership or conservatorship must be reviewed every 90 days and must document the reasons the agency believes other action would better achieve the purposes of section 38.

The statute requires that the institution be placed in receivership if the institution continues to be critically undercapitalized on average during the fourth quarter after the institution initially became critically undercapitalized, unless certain specific statutory requirements are met. To be eligible for the exception, the institution must: (1) Have positive net worth, (2) be in substantial compliance with an approved capital restoration plan, (3) be profitable or have an upward trend in earnings, and (4) have reduced its ratio of nonperforming loans to total loans. In addition, the head of the appropriate Federal banking agency for the institution and the Chairperson of the FDIC must both certify that the institution is viable and not expected to fail.

Critically undercapitalized institutions are also prohibited, beginning 60 days after becoming critically undercapitalized, from making any payment of principal or interest on subordinated debt issued by the institution without the prior approval of the FDIC. Section 38 does not prevent unpaid interest from accruing on subordinated debt under the terms of the debt instrument.

Section 38(i) of the FDI Act also provides that the FDIC, by regulation or order, must restrict the activities of critically undercapitalized institutions. At a minimum, the FDIC must prohibit a critically undercapitalized institution from doing any of the following without the prior written approval of the FDIC:

- Entering into any material transaction other than in the usual course of business. Such activities include any investment, expansion, acquisition, sale of assets or other similar action where the institution would have to notify its appropriate Federal banking agency;
- Extending credit for any highly leveraged transaction (HLT);
- Amending the institution's charter or bylaws unless required to do so in order to carry out any other requirement of any law, regulation or order;
- Making any material change in its accounting methods;
- Engaging in any "covered transactions" within the meaning of section 23A(b) of the Federal Reserve Act (12 U.S.C. 371c), which concerns affiliate transactions;
- Paying excessive compensation or bonuses; and
- Paying interest on new or renewed liabilities at a rate which would increase the institution's weighted average cost of funds to a level significantly exceeding the prevailing rates in the institution's normal market areas.

Pursuant to section 38(j) of the FDI Act, none of these restrictions apply (1) to institutions in conservatorship for which the FDIC or RTC has been appointed the conservator or (2) to any bridge bank that is wholly owned by the FDIC or the RTC. Pursuant to section 38(o)(2) of the FDI Act, none of these restrictions shall apply, before July 1, 1994, to any insured savings association if:

(a) The savings association had submitted a plan meeting the requirements of section 5(t)(A)(ii) of the Home Owners' Loan Act (12 U.S.C. 1464(t)(A)(ii));

(b) The Director of OTS had accepted the plan; and

(c) The savings association remains in compliance with the plan or is operating under a written agreement with the appropriate Federal banking agency.

IV. Discussion of Final Rules and Public Comments

The agencies received a total of 92 comment letters from interested persons regarding the proposed rules implementing section 38. Sixty of the commenters were from banks, thrifts and bank and thrift holding companies, while nineteen were from industry trade associations and organizations. Eight were from Federal Reserve Banks. In addition, there were five from law firms and other organizations and individuals.

The comments provided a number of suggestions for clarifying or modifying the proposed rule. These are discussed below.

Many of the commenters supported the underlying purpose of prompt corrective action. However, several expressed concern that section 38 unduly restricts regulatory flexibility and discretion. Several commenters urged, as a general matter, that the agencies retain as much flexibility as possible in implementing the rules governing prompt corrective action and in administering the requirements of section 38. These commenters argued that capital alone is an inexact measure of the financial strength of an institution, and is only one of a number of measures that must be considered in determining the financial strength of an insured institution. Commenters argued that a narrow focus on capital levels to the exclusion of other indications of financial strength could result in unnecessary and counterproductive actions being taken against financially sound institutions. To avoid this result, many commenters argued that the agencies should adopt flexible rules that permit the agencies as much discretion as possible in determining when to take action under section 38 and what actions are appropriate.

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The agencies have attempted to address this concern to the extent possible under the statute. Section 38 establishes a framework that is triggered by the capital levels of insured institutions, and subjects an insured institution that has capital below the regulatory minimum levels to several mandatory provisions that apply without any agency action. Section 38 also authorizes the agencies, in their discretion, to impose a number of additional requirements and proscriptions on an institution that is undercapitalized, significantly undercapitalized, or critically undercapitalized. The statute permits the agencies to tailor these discretionary supervisory actions to the specific problems faced by individual institutions, and the final rules retain this flexibility.

In addition, commenters generally were concerned that the agencies provide adequate procedural protections to insured institutions and individuals prior to taking any discretionary actions under section 38. The agencies have established procedures in the rule to give affected institutions and persons notice of, and a right to participate in the process for determining, discretionary actions taken by the agency under section 38. These procedures include the general right to advance notice of any action contemplated by the agency, and the right to provide the agency with any information that an affected institution or person believes should be considered by the agency in exercising its discretion under the statute. These procedures provide a mechanism for an institution to identify facts and circumstances that the agency should consider in determining appropriate action for that institution, and are intended to supplement informal discussions that ordinarily occur between an institution that has less than adequate capital and the institution's appropriate Federal banking agency.

A. Capital Measures

For purposes of defining each of the capital categories (except for the critically undercapitalized category), section 38(c) requires the agencies to prescribe capital standards that include a leverage limit and a risk-based capital requirement. The agencies may establish additional capital measures for these categories if additional capital measures would serve the purposes of section 38. In addition, section 38 permits the agencies to rescind the leverage limit or the risk-based capital measure if the Federal banking agencies concur that either measure is no longer an appropriate means for carrying out the purposes of section 38.

The agencies proposed to adopt the leverage limit and the total risk-based capital measure in defining the capital categories other than the critically undercapitalized category. In addition, the agencies proposed to adopt the Tier 1 risk-based capital ratio as a capital measure in defining these capital categories.

Most commenters supported or did not object to the proposal to adopt these three capital measures. Commenters expressed a strong preference for using capital measures and definitions that are currently in place in order to reduce the burden and costs associated with calculating the capital category of an institution.

Several commenters suggested that the agencies eliminate one or more of the proposed capital measures. In particular, a small number of commenters argued that the agencies should not adopt a leverage ratio as a capital measure. Several other commenters argued that the agencies should not establish a separate threshold for Tier 1 capital to risk-weighted assets. A few commenters argued that the agencies should rely solely on the ratio of Tier 1 capital to risk-weighted assets and should eliminate use of the ratio of total capital to risk-weighted assets and the leverage ratio. Finally, one commenter suggested that the agencies rely only on the leverage ratio for smaller institutions that are not internationally active, dropping the risk-based capital tests for these institutions.

The agencies have determined to adopt the three capital measures originally proposed for defining whether an institution is well-capitalized, adequately capitalized, undercapitalized, or significantly undercapitalized. Section 38 requires the agencies to employ a risk-based capital requirement and the leverage ratio as capital measures for each capital category unless the agencies all agree that these capital measures are no longer an appropriate means for carrying out the purposes of section 38. The agencies continue to believe that the ratio of total capital to risk-weighted assets represents an appropriate capital measure. In addition, the ratio of Tier 1 capital to total assets, which is a component of the total risk-weighted capital ratio, represents an important measure of the highest quality capital available to the institution to absorb losses. Both the total risk-weighted capital ratio and the Tier 1 risk-weighted capital ratios are recognized in the Basle Accord and are elements of the minimum capital adequacy standards currently employed by the Federal banking agencies.

The agencies have considered the suggestion of commenters that the leverage ratio be eliminated as an appropriate capital measure. The agencies do not believe that elimination of the leverage ratio is appropriate at this time. One of the rationales for retaining a leverage ratio after the risk-based capital measure was introduced was that the risk-based capital measure is focused on credit-related risk, and does not explicitly factor in other risks, particularly interest rate risk.

However, the agencies noted in the request for comment that revisions to the risk-based capital standards mandated by FDICIA may warrant review of the capital measures and thresholds specified under section 38 at a later date. Section 305 of FDICIA, which amends section 18 of the FDI Act, requires the agencies to revise their risk-based capital standards by no later than June 1993 to take into account interest rate risk, concentration of credit risk, and the risks of nontraditional activities and multi-family mortgages. The agencies intend to lower or eliminate the leverage capital component from the definitions of "well capitalized," "adequately capitalized," and "undercapitalized" after the risk-based capital standards have been revised by each Federal banking agency to take into account interest rate risk as required by section 305 of FDICIA and after experience has been gained with such standards. The agencies acknowledge the requirements of section 38(c) of the FDI Act and would comply with those requirements, to the extent they apply, before taking any such action.[5] Several commenters supported reconsideration of the need for the leverage ratio after completion of the review required by section 305.

B. Definition of Capital Terms

The agencies had proposed to adopt the same definitions of capital terms for purposes of the prompt corrective action

[5] Section 38(c) of the FDI Act requires that the capital standards prescribed under that section by each appropriate Federal banking agency shall include a leverage limit and a risk-based capital requirement, as well as any other additional relevant capital measures needed to carry out the purpose of section 38 and implemented by regulation. However, an appropriate Federal banking agency may, by regulation, rescind any relevant capital measure required by section 38, upon determining (with the concurrence of the other Federal banking agencies) that the measure is no longer an appropriate means for carrying out the purpose of section 38.

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provisions of section 38 as are currently used under the capital adequacy guidelines or regulations adopted by the agencies. The commenters strongly favored this approach because it would reduce the burden and complexity that could result from the use of new or modified capital definitions, and would minimize the possibility that an institution may be uncertain regarding its capital levels for purposes of section 38. Accordingly, the final rules adopt the definitions of the various capital elements and terms currently used in the agencies' existing capital adequacy guidelines and regulations.

The agencies requested comment regarding the appropriate period for calculation of capital levels. Under current reporting requirements, as specified in the instructions to the Call Report, the level of capital of an institution is generally calculated as the ratio of the institution's quarter-end capital to the quarterly average of its total assets (in the case of the leverage ratio) or its quarter-end risk-weighted assets (in the case of the risk-based capital ratios).[6] The agencies sought comment on whether capital calculations should be based on the same period calculations for purposes of section 38. The agencies also requested comment on the feasibility of requiring institutions to make a daily calculation of various capital measures.

Commenters generally supported applying the same periods for capital calculations under section 38 as are currently used under the agencies' capital adequacy standards. The commenters also strongly objected to any requirement that capital calculations be required on a daily basis for purposes of implementing section 38. The commenters argued that daily calculations would substantially increase the reporting burden and costs for many institutions. In addition, commenters contended that daily calculations present a distorted picture of the capital position of an institution by focusing on individual daily events (such as a temporary increase in deposits in connection with a lock-box operation) and do not take account of related actions that occur within a reasonably short period or remedial actions that are readily available to the institution (such as a scheduled withdrawal of deposits from a lock-box account). The commenters argued that the calculation periods currently adopted by the agencies in their capital adequacy standards provide a more accurate and reliable estimation of the capital levels of institutions.

Based on these comments, the final rules use the same calculation periods for purposes of section 38 as are currently employed under the agencies' capital adequacy standards. The agencies have determined not to require the daily calculation of capital for purposes of section 38 at this time.

C. Specific Capital Levels for Five Capital Categories

The agencies proposed specific capital levels defining each capital category. Under the standards set forth in section 38, an institution is deemed to be adequately capitalized if it meets the required minimum level for each relevant capital measure. Thus, the agencies proposed to set the capital levels for the adequately capitalized category generally at the same levels as the minimum ratios established under the existing minimum capital adequacy rules and guidelines adopted by the agencies. These minimums are 8 percent for the total risk-based capital ratio, 4 percent for the Tier 1 risk-based capital ratio, and 4 percent for the Tier 1 leverage ratio (3 percent for composite 1-rated banks and savings associations, subject to appropriate Federal banking agency guidelines). An institution would have to meet all these minimums in order to be deemed adequately capitalized.

The statute provides specific guidance as to the capital level for defining a critically undercapitalized institution. Section 38 requires that a critically undercapitalized institution be defined by reference to the institution's ratio of tangible equity to total assets. The statute requires the agencies to establish the threshold ratio for defining a critically undercapitalized institution at no lower than 2 percent.

Taking the capital levels for the adequately capitalized and critically undercapitalized categories as benchmarks, the agencies proposed that the capital levels for the undercapitalized category be defined as any level under 8 percent for the total risk-based capital ratio, under 4 percent for the Tier 1 risk-based capital ratio, or under 4 percent for the Tier 1 leverage ratio (under 3 percent for composite 1-rated banks and savings associations, subject to appropriate Federal banking agency guidelines). An institution would be considered undercapitalized if it were below the specified capital level for any of the three capital measures.

Further, the capital levels for significantly undercapitalized institutions were defined as any level under 6 percent for the total risk-based capital ratio, under 3 percent for the Tier 1 risk-based capital ratio, or under 3 percent for the Tier 1 leverage ratio. An institution would be considered significantly undercapitalized if it were below the specified capital level for any of the three capital measures. Under the proposed definitions, an institution that is significantly undercapitalized also would be deemed to be undercapitalized. Similarly, an institution that is critically undercapitalized also would be deemed to be significantly undercapitalized and undercapitalized. The overlap between these categories is contemplated by the statute and has the effect of applying to significantly undercapitalized institutions and to critically undercapitalized institutions any provisions of section 38 that are applicable to undercapitalized institutions.

The agencies proposed establishing the minimum total risk-based capital level for the well capitalized category at 10 percent and setting the minimum leverage capital level for this category at 5 percent. To emphasize the importance the agencies place on Tier 1 capital, the agencies proposed that the minimum level for the Tier 1 risk-based capital ratio be set at 6 percent for the well capitalized category.

Many commenters indicated agreement with the capital thresholds proposed by the agencies. Several commenters were concerned that the levels be applied equally to institutions of all sizes. Other commenters argued that the capital levels set for the well-capitalized category were established at too high a level. These commenters noted that the standard for well capitalized institutions would require an institution to hold 25 percent more total risk-based capital, 50 percent more Tier 1 capital, and 66 percent more leverage capital than an adequately capitalized institution.

Commenters stated that they were particularly concerned about the well-capitalized levels because several of the newly proposed rules required by FDICIA impose new constraints on institutions that are not within the well-capitalized category. Commenters believe that these provisions will have the practical effect of establishing the well-capitalized category as the minimum acceptable capital category for most institutions. Several commenters argued that high capital thresholds for the well-capitalized category would have significant implications in the near term for the availability of credit in the

[6] Savings associations report their capital amounts on their Thrift Financial Reports based on end of the quarter total assets and total risk-weighted assets.

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United States, as depository institutions attempt to meet the higher capital levels of the well-capitalized category through slower asset growth or shrinkage of assets. These commenters also argued that establishing high capital thresholds for this category would significantly impair the ability of domestic depository institutions to compete against foreign institutions that are not subject to this capital-based regulatory and supervisory framework. In order to address these potential effects, these commenters argued that the capital thresholds should be lowered, or phased-in over a period of time.

On the other hand, a few commenters argued that the capital levels proposed by the agencies were too low. In particular, these commenters contended that a higher threshold for the definition of the critically undercapitalized category was necessary in order to minimize potential losses to the federal deposit insurance funds. One commenter argued that, at the thresholds in the proposal, the number of institutions that would qualify for the well-capitalized category was too high and included a large number of institutions that had received unsatisfactory examination ratings. These commenters argued that higher thresholds for each of the capital categories would permit the agencies to initiate supervisory actions under section 38 against a greater number of institutions, thereby permitting action while an institution is still sufficiently healthy to reverse its deterioration.

After considering the comments, the agencies have determined at this time to adopt the capital thresholds as proposed. In the agencies' view the proposed thresholds strike a reasonable balance between the statutory requirements on the one hand, and the need to promote safe and sound banking conditions in a manner that gives due consideration to the international capital standards to which the United States and the other G–10 countries have agreed on the other hand. The agencies believe that such consideration is appropriate in view of the competitive pressures faced by U.S. banks operating in international markets with foreign banks adhering to these standards. In this regard, as with the capital adequacy standards currently adopted by the agencies, the thresholds adopted in the final rules under section 38 will apply to each insured depository institution, regardless of the size of the institution. Comparable thresholds are applied to insured branches of foreign banks.

In establishing these thresholds, the agencies recognize that capital ratios alone are not fully indicative of the capital strength of an institution. The agencies are aware, for example, that some poorly-rated depository institutions have capital ratios above the specified minimums for the well-capitalized and adequately capitalized categories. One reason that some poorly-rated institutions qualify as well capitalized for prompt corrective action purposes is that capital is a lagging indicator of problems of insured depository institutions. In part for this reason, examiners traditionally have reached judgments on an institution's capital needs by also taking into account a range of factors such as interest rate risk and concentration risk. As noted above, the agencies have under way initiatives mandated by FDICIA to review their risk-based capital standards to ensure that they take adequate account of such risks, and also have been engaged in a project under the Federal Financial Institutions Examination Council (FFIEC) to refine and improve procedures for assessing the reserving policies and practices of individual institutions. After those projects have been completed and improvements implemented and assessed, the agencies intend to revisit the question of how the specifications for the well-capitalized category may need to be modified or adjusted.

Several commenters argued that an institution that nominally has capital above the threshold for well-capitalized institutions should not be excluded from that category because the institution is subject to an agency order or directive to raise additional capital. These commenters argued that use of capital directives or agency orders to raise additional capital as a means of defining the well-capitalized category is not contemplated by section 38, and is not consistent with the statute's instruction that capital categories be defined by reference to the actual capital level of an institution.

To qualify as a well-capitalized institution under section 38, the capital levels of an institution must significantly exceed the required minimum level for each relevant capital category. The agencies believe that an institution that is subject to an agency order or directive to raise capital or to maintain capital at a higher capital level does not meet the statutory definition of a well-capitalized institution. Instead, institutions that have been ordered to raise capital or maintain a higher level of capital are subject to an agency determination that, given the particular circumstances and financial condition of the institution, the capital level of the institution is inadequate or minimally adequate. Accordingly, the agencies have adopted the definition of the well-capitalized category as proposed, and have retained the provision disqualifying from the well-capitalized category any institution that is subject to an agency order or directive to meet and maintain a specific capital category. The agencies have modified the language of this section to clarify that the provision applies only to written agreements, orders, capital directives, and prompt corrective action directives that are issued under certain provisions of the FDI Act, the International Lending Supervision Act, the Home Owners' Loan Act, or regulations implementing these laws.

D. Critically Undercapitalized Institutions

The statute requires that the critically undercapitalized category be based on the ratio of tangible equity to total assets of the institution. Section 38 requires that the minimum ratio for this category be established at a level of tangible equity that is no less than 2 percent of the institution's total assets, and that is no higher than the ratio equal to 65 percent of the required minimum level of capital under the leverage limit. The agencies may, by regulation, specify additional capital measures (such as a risk-based capital ratio) in defining the critically undercapitalized category. Any such measures may not, without the concurrence of the FDIC, be set at a level lower than the level specified by the FDIC for insured state-chartered banks that are not members of the Federal Reserve System.

The agencies proposed to define the level for the critically undercapitalized category as a ratio of tangible equity to total assets of 2 percent or less. The agencies did not propose to establish any additional capital measures for the critically undercapitalized category. The commenters that addressed these matters favored the capital level proposed by the agencies for this capital category and generally agreed that no additional capital measure was necessary to define this category. Accordingly, the final rules adopt the original proposal to define an institution as critically undercapitalized if the institution has a ratio of tangible equity to total assets of 2.0 percent or less.

Section 38 provides that the critically undercapitalized category must be defined by reference to the ratio of tangible equity to total assets of an institution. However, section 38 does not define the term "tangible equity." Moreover, the term is not currently defined by the Federal banking agencies

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in connection with their capital adequacy standards or by the accounting profession. To implement this provision, the agencies had proposed to define the ratio of tangible equity to total assets in the same manner as the leverage ratio currently established by the agencies by regulation or guideline, which is the ratio of Tier 1 capital to total average assets.

A significant number of commenters argued that the agencies should modify the proposed definition of tangible equity to permit the inclusion of all forms of equity capital, in particular cumulative perpetual preferred stock. These commenters noted that the OCC recognizes the level of cumulative perpetual preferred stock in determining whether a national bank is insolvent for purposes of the National Bank Act.

In adopting the final rules, the agencies have determined to define tangible equity to include the core capital elements recognized in the calculation of Tier 1 capital. In addition, the final rule includes cumulative perpetual preferred stock issued by the institution and related surplus. The agencies recognize that cumulative perpetual preferred stock provides a cushion against losses suffered by the institution and provides protection to the deposit insurance funds. The agencies have determined not to include other instruments, however. The agencies are concerned that the inclusion of other types of instruments, in particular instruments that are hybrids of equity and debt, will distort the capital raising efforts of depository institutions and result in the development and issuance of instruments that, while providing some protection against loss, place a significant burden on the earnings of the institution over the life of the instrument and on the ability of the institution to raise additional capital.

Several commenters also argued that the agencies should not require the deduction of all intangible assets in determining whether an institution is critically undercapitalized. These commenters argued that many assets that are considered intangible in fact have significant value and serve as a ready and marketable source of liquidity to troubled institutions.

In determining whether equity is "tangible" for purposes of the final rule under section 38, the agencies have determined to require the deduction of all intangible assets with one exception.[7] The agencies have sought public comment on a proposal to amend their capital adequacy standards regarding inclusion of certain purchased mortgage servicing rights in the calculation of Tier 1 capital. This proposal is in response to section 475 of FDICIA, which requires the Federal banking agencies to determine whether a portion of certain purchased mortgage servicing rights should be included in the definition of "tangible capital."

To comply with this statutory provision, the agencies must determine whether certain purchased mortgage servicing rights have sufficient value to warrant a determination that these assets should not be treated as intangible assets for purposes of the calculation of tangible capital. The agencies believe that, to the extent that purchased mortgage servicing rights are determined under this statutory provision to be properly included in "tangible capital," these assets should be given identical treatment in the calculation of tangible equity under section 38.[8]

E. Notice of Capital Category

Under section 38, an institution becomes subject to certain mandatory provisions on the basis of the capital category of the institution. These mandatory provisions apply immediately without agency action. As noted above, an undercapitalized institution is immediately subject to a restriction on the payment of dividends and management fees, a limitation on asset growth and expansion, and an obligation to file an acceptable capital restoration plan. In addition to these requirements, an institution that is significantly undercapitalized or critically undercapitalized is subject to a limitation on the payment of bonuses or raises to senior executive officers. A number of other mandatory restrictions are imposed on critically undercapitalized institutions. Moreover, once an institution is deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, section 38 grants the appropriate Federal banking agency for the institution discretion to take a number of supervisory actions to address the problems of the institution.

The final rules include provisions for an institution and its appropriate Federal banking agency to determine the capital category of the institution, and, thereby to determine when the provisions of section 38 are applicable. Commenters supported the agencies' proposal to base capital calculations principally on the Call Report filed by each institution and on an institution's examination.

Accordingly, the final rules retain provisions that deem an institution to be aware of its capital category as of the date that the Call Report is required to be filed. Similarly, the institution is deemed to be notified of its capital category as of the date that the examination report is provided to the institution.

The final rules also retain the provision permitting the agencies to determine the capital category of an institution based on other information available to the agency, including information obtained in the applications process, through other reports filed by the institution under the banking laws or the securities laws, or in public announcements by the institution. The final rules provide that, in the event that the agency determines the capital category of the institution on the basis of other information, the agency must notify the institution in writing of its determination.

The agencies also requested comment on whether to require capital calculations to be made daily or monthly for purposes of applying the provisions of section 38. A significant number of commenters opposed any requirement that institutions make daily calculations of capital. A number of commenters also argued that daily calculations of capital would present a distorted view of the capital position of an institution because daily calculations emphasize the timing of events and do not permit consideration of offsetting events that are reasonably expected to occur at a later date. These commenters also argued that requiring institutions to calculate capital levels on a daily basis would be impractical, particularly for institutions with extensive branch networks or with foreign offices, and would impose significant added costs and burdens on insured institutions. As explained above, the agencies have not adopted provisions requiring institutions to make daily calculations or file daily reports of capital levels for purposes of section 38.

[7] For savings associations, pursuant to section 5(t) of the Home Owners' Loan Act (12 U.S.C. 1464(t)), enacted as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, certain qualifying supervisory goodwill will also be included in "tangible equity."

[8] Several commenters argued that the definition of tangible equity should include investments in certain types of subsidiaries, which savings associations are required to deduct for purposes of their general capital calculations. The OTS has determined that investments in these subsidiaries will be included in the definition of tangible equity only to the extent permitted in the definition of Tier 1 capital under the Home Owners' Loan Act's transitional rule, which expires July 1, 1994, 12 U.S.C. 1464(t)(5)(D).

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Several commenters argued that similar burden would result from the agencies' proposal to establish a procedure that requires an institution to notify the appropriate agency within 5 days of any change in the institution's capital position that would cause the institution to be within a different capital category. The agencies had proposed this notification procedure as a means of supplementing the use of Call Reports and periodic examinations for determining the capital category of insured institutions.

The agencies have made several revisions to the proposed notification procedures to address commenters' concerns. The final rules have been modified to require an institution to notify the appropriate agency only of material events that affect the capital position of the institution. The notice period has also been extended to 15 days from the 5 days originally proposed. The determination of whether the capital category of the institution has changed may be made by reference to the most recent Call Report or examination report.

The rule retains the original proposal that the capital category of the institution will not change until the appropriate agency has reviewed the data provided by the institution along with any explanation offered by the institution. Following review of this information, the agency will determine whether an adjustment to the capital category of the institution is appropriate.

Finally, in response to several comments, the rule has been modified to eliminate the requirement that the institution notify the agency of events that improve the capital level of the institution. Because an institution's capital category is based on the information filed in the most recent Call Report or report of examination, however, an institution that has improved its capital position prior to the time that a new Call Report has been filed or examination report completed would continue to be considered within the capital category reflected in the most recent Call Report or examination report unless the institution voluntarily sought a determination by the agency that the institution is in a different capital category.

The agencies believe that the revised notification procedures address the concerns raised by these commenters while at the same time still providing adequate notice to the appropriate Federal banking agency when an institution's capital category has changed between filing of Call Reports or examinations. The agencies believe that failure to recognize material events that occur during this period could result in delay in application of the supervisory requirements of section 38, including the mandatory provisions of the statute.

F. Procedures Governing Agency Action

1. In General

The final rules establish procedures governing four types of agency action that may be taken under section 38.[9] In three cases, the final rules generally require the appropriate agency to provide notice to an insured institution or company of proposed agency action and an opportunity for the institution or company to submit to the agency information that is relevant to the agency's decision before the agency takes final action. In particular, the final rules establish these procedures for: (1) Issuing a directive under section 38 that imposes requirements or restrictions committed to agency discretion on an undercapitalized institution or a company that controls an undercapitalized institution; (2) determining that an institution should be subject to more stringent treatment because the institution is in unsafe or unsound condition; and (3) determining that an institution should be subject to more stringent treatment because the agency deems the institution to be engaged in an unsafe or unsound practice based on the institution's failure to correct certain deficient ratings received in an examination. The final rules also establish a special procedure, as required by section 38, permitting senior executive officers and directors who have been dismissed from an institution as a result of an agency directive an opportunity to petition for reinstatement.

In establishing these procedures, the agencies have attempted to comply with the statutory mandate that the agencies take prompt action to resolve the problems of troubled institutions while also providing affected institutions, companies, and persons the opportunity to be heard at a meaningful time and in a meaningful manner.

2. Procedures for Issuing Prompt Corrective Action Directives

Section 38 imposes certain mandatory restrictions on institutions that are undercapitalized, significantly undercapitalized, or critically undercapitalized. The statute also provides the agencies with discretion to impose a number of supervisory requirements or restrictions on an insured institution that is undercapitalized, significantly undercapitalized or critically undercapitalized, as well as on any company that controls such an institution. These discretionary supervisory actions are described above. The system enacted in section 38 is based on Congress's belief that prompt action must be taken to resolve problems at insured depository institutions at an early enough stage to minimize costs to the federal deposit insurance funds, and ultimately the taxpayer.

The agencies do not believe that the purpose and mandate of section 38 are compromised by, as a general matter, providing institutions notice of proposed agency action under section 38 and an opportunity to submit relevant information to the agency for its consideration. Under the final rules, the appropriate agency will provide written notice to an institution or company prior to issuing a directive as a general matter. The notice must describe the action contemplated by the agency. The institution or company is then provided at least 14 calendar days to submit written arguments and evidence in response to the proposed agency action. Failure to file a timely response constitutes consent to the issuance of the directive and a waiver of the opportunity to appeal. The agency will consider the submission in determining whether to issue the directive.

The agencies reserve the right to issue directives that are effective immediately when the circumstances of a particular case indicate that immediate action is necessary to serve the purpose of prompt corrective action. In these cases, the final rules provide the institution an opportunity to seek modification or rescission of the directive on an expedited basis. An institution or company that appeals an immediately effective directive is required to file a written appeal within 14 days of receiving the notice, and the agency must consider the appeal within 60 days of receiving it.

The agencies believe that these procedures afford an adequate and fair opportunity for affected persons to present the agency with argument and information relevant to the agency's action. The procedures adhere to the mandate of section 38 that the agencies take prompt corrective action to resolve the problems of insured depository

[9] The agencies will not be required to grant administrative review if an institution, company, or person consents to the action to be taken by the agency either as initially proposed by the agencies or as modified by mutual agreement. Actions taken with such consent have the same legal affect and are enforceable to the same extent and by the same means as actions taken upon exhaustion of these procedures.

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institutions at the least possible long-term loss to the deposit insurance fund while providing institutions with an opportunity for agency review.

Commenters raised various objections to the procedures proposed by the agencies for issuing directives under section 38. Some commenters stated that an oral hearing is required by principles of due process and fundamental fairness before an agency can issue a prompt corrective action directive. Certain other commenters expressed concern about the agencies' proposal to allow issuance of a directive without prior notice to the institution in limited cases; other commenters recommended that such an immediately effective directive be issued only after a determination by the agency head that exigent circumstances require immediate action.

The final rules do not adopt the suggestion of several commenters that the agencies provide for an oral hearing in connection with the issuance of a prompt corrective action directive. The agencies believe that the procedures for prior notice and an opportunity for submission of written argument and information are sufficient in light of the purpose and mandate of section 38. As explained above, the language and legislative history of section 38 indicate that Congress intended agency action under section 38 to be taken as promptly as possible. 12 U.S.C. 1831o(a)(2); see also S. Rep. No. 102–167, 102d Cong., 1st Sess. (1991) ("The prompt corrective action system will require regulators to act at the first sign of trouble.").

In addition, Congress clearly indicated those occasions when it believed that an oral hearing is appropriate in connection with actions taken under section 38. Congress gave no indication in either the statutory language or legislative history that it intended to require an oral hearing in connection with supervisory actions committed to agency discretion under section 38.

Finally, the agencies believe that the provision for written submissions prior to issuance of a directive affords adversely affected parties an opportunity to be heard "at a meaningful time and in a meaningful manner." *Mathews* v. *Eldridge*, 424 U.S. 319, 333 (1976); *see FDIC* v. *Mallen*, 486 U.S. 230 (1988) (upholding post-deprivation hearing in case of suspension or removal of a bank officer charged with a felony); *Federal Deposit Ins. Corp.* v. *Bank of Coushatta*, 930 F.2d 1122 (5th Cir. 1991), *cert. denied*, 112 S. Ct. 170 (1992) (affirming hearing procedures for FDIC capital directive).

In special cases where immediate action is necessary and prior notice has not been given, the institution is given prompt post-directive administrative review. The courts have found similar post-deprivation procedures to be adequate when necessary to protect the public interest. See *Mallen*, 486 U.S. at 243; *Soranno's Gasco, Inc.* v. *Morgan*, 874 F.2d 1310, 1317–18 (9th Cir. 1989) (power to suspend permit immediately is necessitated by state's interest in enforcing pollution control laws).

Several commenters argued that the 14-day deadline for submission of a response to a proposed directive was too short, favoring deadlines from 30 to 90 days. The final rule provides at least 14 days for submission of a response, but permits the agency to extend that period in individual cases as appropriate.

3. Dismissal of Directors or Senior Executive Officers

Section 38 provides that a director or senior executive officer who is dismissed by an institution in compliance with an agency directive may obtain review of the dismissal by filing, within ten days, a petition for reinstatement with the agency that ordered the dismissal. The statute also provides that the petitioner shall have the opportunity to submit written materials in support of the petition and to appear at a hearing before member(s) or designated employee(s) of the agency. Under the statute, the hearing shall occur within 30 days of the filing of the petition unless the petitioner requests a later date. Under the final rules, within 20 days of the closing of the hearing record, the presiding officer must make a recommendation to the agency regarding the petition for reinstatement, and the agency shall issue a decision within 60 days of the date of the closing of the hearing record.

The statute envisions a post-dismissal hearing procedure, as it refers to the appeal as a "petition for reinstatement" and sets a short time for agency decision following the hearing. Accordingly, the proposed regulation required that an institution ordered to dismiss a senior executive officer or director take that action immediately upon receiving a final directive requiring that action.

The agencies also proposed that any officer or director who is dismissed in compliance with an agency directive under section 38 be provided an opportunity to petition the agency for reinstatement within the statutorily prescribed period, and be afforded an opportunity for an informal agency hearing. The petitioner was provided the right to appear at the hearing, with counsel, and to submit written materials and present oral argument.

The proposed regulation also incorporated the statutory burden of proof imposed upon an officer or director seeking reinstatement. When the dismissal order is based upon an institution's capital category or its failure to submit or implement a capital restoration plan, the petitioner must prove that his or her continued employment would materially strengthen the institution's ability to become adequately capitalized. When the dismissal order is based upon a reclassification of an institution on grounds of unsafe or unsound condition or practice, the petitioner must prove that his or her continued employment would materially strengthen the institution's ability to correct the condition or practice. The agencies proposed to restrict the ability of an officer or director seeking reinstatement to challenge the capital category to which the institution has been assigned.

Commenters generally recognized that most of the procedures for review of a dismissal are set out in the statute and that the agency proposal adopted these statutory standards. Several commenters urged the agencies to amend the proposal to allow dismissed officers and directors to present, as a matter of right, oral testimony or witnesses at the agency hearing. The proposal permitted the presentation of oral testimony or witnesses only with the permission of the presiding officer. The commenters argued that the petitioner must meet a heavy burden of proof in order to be reinstated, and should be permitted to meet that burden through the presentation of oral testimony.

The agencies have decided to retain the provision providing that petitioners may present oral testimony and witnesses with the permission of the presiding officer without providing an absolute right to presentation of oral testimony. Under the proposed procedures, petitioners have the right to submit affidavits or other written statements from any person in making their case. In addition, petitioners may request permission of the presiding officer to present oral testimony or witnesses. Any decision by a presiding officer not to permit oral testimony is subject to review when the agency determines the action that is appropriate on the basis of the record compiled at the hearing.

Commenters also expressed concern that neither the statute nor the proposed rule requires an agency to identify any connection between the conduct of the officer or director and the financial deficiencies experienced by the insured

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institution before dismissing or upholding the dismissal of the officer or director. Commenters urged that the agencies consider whether the conduct of an officer or director contributed to the troubled condition of the institution in deciding whether to dismiss the officer or director and in considering a petition for reinstatement.

The agencies note that the burden of proof necessary for reinstatement is established by statute for all petitions for reinstatement. The agencies do not have discretion to establish an alternative burden of proof for cases in which an officer or director believes that he or she has not contributed to the financial weakness of the institution. However, the agencies note that the statute does not limit the types of arguments or evidence that may be presented by a petitioner in meeting the statutory burden of proof. In this regard, the agencies believe that evidence concerning the past performance of the director or officer at the institution may be relevant to determining whether a director or officer would materially strengthen an institution's ability to address its problems. Accordingly, the final rules adopt the procedures for review of petitions for reinstatement as proposed by the agencies.

Finally, one commenter argued that a dismissed officer or director should be allowed to challenge the bank's capital category, since the bank's capital category is the basis for the dismissal. The agencies have decided not to adopt this restriction in the final rule.

4. More Stringent Treatment Based on Non-Capital Supervisory Criteria

In establishing a system of prompt corrective action based primarily on the capital level of each institution, Congress recognized that factors other than capital should in certain circumstances be used to assess the financial condition of an institution. In providing for more stringent treatment based on non-capital indications of financial condition, Congress appears to have had the same concern that underlies prompt corrective action generally: preventing loss to the deposit insurance funds. See S. Rep No. 102–167, 32–38 (giving regulators "flexibility to discipline institutions based on criteria other than capital * * * will help reduce deposit insurance losses * * *."). If actions taken based on criteria other than capital are to be effective, they must be taken promptly.

Section 38 provides that the appropriate Federal banking agency may, under certain circumstances, reclassify a well capitalized insured depository institution as adequately capitalized. Section 38 also permits the appropriate agency to require an adequately capitalized or undercapitalized institution to comply with the supervisory provisions as if the institution were in the next lower category (but not treat a significantly undercapitalized institution as critically undercapitalized) based on supervisory information other than the capital levels of the institution. (While the agencies recognize that these provisions are not strictly a reclassification of the institution in all cases, reclassification to the adequately capitalized category and treatment of an institution as if it were in the next lower capital category are referred to collectively in this document and in the final rules as a "reclassification.")

The statute provides that an institution may be reclassified if the appropriate Federal banking agency determines (after notice and opportunity for hearing) that [the institution] is in an unsafe or unsound condition or, pursuant to section 8(b) (8), deems the institution to be engaging in an unsafe or unsound practice. 12 U.S.C. 1831o(g). Section 8(b)(8) of the FDI Act was amended by FDICIA to provide that an institution may be deemed to be engaged in an unsafe or unsound practice if (1) the institution has received a less-than-satisfactory rating in its most recent examination report for assets, management, earnings or liquidity [10], and (2) the institution has not corrected the deficiency. 12 U.S.C. 1818(b)(8).

Relying on the statutory language, the proposed rule provided different procedures for review of reclassifications based on unsafe or unsound condition and those based on unsafe or unsound practice. In the case of unsafe or unsound condition, the proposed regulation provided for notice to the institution and an opportunity for an informal hearing prior to the reclassification; in the case of unsafe or unsound practice, the proposed regulation provided for notice to the institution, a 14-day period in which the institution could make a written submission objecting to the reclassification, and agency review of that submission prior to any reclassification.

Several commenters argued that the agencies should provide a formal administrative hearing in connection with reclassifications that are based on a finding that the institution is in unsafe or unsound condition. Commenters argued that the provision in section 38 requiring that this type of reclassification occur only "after notice and opportunity for hearing" indicates a Congressional intent that a full administrative hearing be given in these cases. Commenters also contended that principles of fundamental fairness require a full hearing in these cases.

The agencies do not believe that the statute or the principles of fairness require that a formal administrative hearing be afforded in the case of reclassifications based on a finding of unsafe and unsound condition. The courts have determined that the statutory language—"after notice and opportunity for hearing"—does not require a formal hearing. See, *e.g.*, *United States* v. *Florida East Coast Ry.*, 410 U.S. 224, 240 (1973) (use of the word "hearing" in statute "does not necessarily embrace either the right to present evidence orally and to cross-examine opposing witnesses, or the right to present oral argument to the agency's decisionmaker"). Where, as here, the statute does not contain the phrase "hearing on the record" and the legislative history does not indicate a Congressional intent to provide for a formal hearing, the agency may meet the statutory requirements by providing an informal hearing. See, *e.g.*, *Independent U.S. Tanker Owner Comm.* v. *Lewis*, 690 F.2d 908, 922 n.63 (D.C. Cir. 1982).

The final rules adopt the agencies' proposal to provide institutions with an opportunity for an informal hearing in connection with a reclassification based on the institution's condition. Under the procedures adopted by the agencies, an institution will be provided prior written notice of any intention by the agencies to reclassify the institution, along with an explanation of the reasons for the proposed reclassification. The institution is provided an opportunity to present written testimony and argument and an opportunity for an informal hearing prior to the reclassification. The informal hearing is available as a matter of right. At the informal hearing, the institution may present written and oral argument, written evidence and testimony, and, where appropriate, oral testimony.

The agencies believe that these procedures, which include an opportunity for an informal hearing, provide institutions with an adequate opportunity to be heard prior to agency action. These procedures also ensure that agency action in connection with an institution whose nominal capital levels do not provide an accurate indication of the condition of the institution, will be prompt, as mandated by section 38.

[10] For savings associations, the equivalent categories are the management, assets, risk, and operations components of the MACRO rating.

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Several commenters objected to the agency proposal to establish a different procedure—without an opportunity for a hearing—for the reclassification of an institution that has received an unsatisfactory examination rating and failed to correct the deficiency. These commenters favored providing at least an informal hearing in the case of both types of reclassification. Commenters argued that the consequences of reclassification were identical, whether based on an examination rating or on a finding that the institution is in unsafe or unsound condition, and, therefore, a hearing should be provided in both cases.

Commenters also argued that the apparent difference in the wording of the statute in authorizing the two methods for reclassification of insured institutions did not indicate a Congressional intent to deprive institutions of a hearing in connection with a reclassification based on an examination rating. Rather, commenters argued that insured institutions should be afforded an opportunity for a hearing prior to reclassification based on an unsatisfactory examination rating because examinations are inherently subjective and the consequences to the institution of reclassification, particularly for an institution that is nominally adequately capitalized, could be significant. Accordingly, commenters contended that principles of fundamental fairness required that an opportunity for a hearing be provided prior to a reclassification based on an examination rating.

Following consideration of the comments, the agencies have modified the final rules to provide an opportunity for an informal hearing in the case of both types of reclassifications. The agencies believe that providing an opportunity for an informal hearing prior to reclassification based on an unsatisfactory examination rating will provide the institution with an adequate and meaningful opportunity to provide the agency with information and argument relevant to the agency's decision without substantially delaying the ability of the agencies to take prompt action as required by section 38.

The agencies do not believe that a formal hearing is required in connection with reclassifications based on an unsatisfactory examination rating. The statute does not require a formal hearing on the record in the case of these types of reclassifications. Instead, the statute grants the agencies significant discretion in reclassifying an institution that has received an unsatisfactory examination rating and failed to correct the deficiency.

In addition, the agencies believe that the availability of an informal hearing meets any requirement of fundamental fairness or due process when viewed in context. The examination rating that serves as the trigger for a reclassification is the result of a process that involves substantial participation by the affected institution. This participation includes an opportunity to provide all relevant information to the examiner, and to meet with the examiner with regard to issues that arise during the examination. Moreover, following the examination, each of the agencies provides an informal appeals process whereby an institution can seek review of an examiner's decision at a higher level of the agency. Thus, an institution that has been reclassified based on its examination ratings will have already been afforded substantial opportunity to present evidence and argument prior to any reclassification procedure.

The agencies also note that reclassification of an institution based on an examination rating is not an automatic result of receiving an unsatisfactory rating. Instead, each agency retains discretion to initiate the procedures for reclassification and will do so based on the facts of each case.

Finally, no restrictions or requirements become effective automatically as a result of reclassification. As commenters noted, section 38 does not make institutions that have been reclassified immediately subject to the mandatory provisions of section 38. Instead, section 38 authorizes the appropriate agency, in its discretion, to impose requirements or proscriptions contained in section 38.

Several commenters expressed concern that any use of the reclassification procedures would result in public disclosure of an institution's examination rating. Consequently, these commenters contended that the agencies should never reclassify an institution on the basis of ratings received in an examination report. Several other commenters argued that examination ratings are subjective in nature and should not serve as the basis of reclassification of an institution under section 38.

The agencies expect to use the reclassification provisions of section 38 when appropriate. The agencies believe that steps can be taken to prevent public disclosure of examination ratings, and that use of the reclassification provisions of section 38 is important to ensuring prompt corrective action. The agencies also believe that examination ratings are a proper basis for reclassification under section 38. As noted above, depository institutions participate in the examination process and are afforded an informal appeal of an examiner's judgment. Furthermore, reclassification based on a less-than-satisfactory rating is not automatic, and is left to the agency's discretion, with corresponding procedural protections.

A small number of commenters favored other changes to the reclassification procedures. In particular, one commenter urged that the period for filing a response to a proposed reclassification be lengthened from 14-days to 45 or 60 days. In light of the agencies' decision to provide an opportunity for an informal hearing in connection with reclassifications based on an examination rating, the agencies have determined not to lengthen the time within which an institution may provide its initial written response to a proposed reclassification.

Another commenter suggested delaying the effective date of any reclassification to allow the institution to adjust to new restrictions on its activities. The agencies believe that, because reclassification does not result in the automatic application of any mandatory provision under section 38, it is not necessary to delay the effective date of any reclassification.

Finally, one commenter requested that the agencies provide by regulation that the presiding officer at a hearing not be an individual that has served as an examiner of the institution. The agencies expect to select presiding officers that may render a qualified recommendation to the agency regarding whether reclassification is appropriate, and do not believe that it is necessary or appropriate to specify in the regulation the qualifications of the presiding officer.

5. Enforcement of Directives

Section 8 of the FDI Act, as amended by FDICIA, includes prompt corrective action directives issued pursuant to section 38 among the orders that may be enforced in the courts pursuant to section 8(i)(1), and also makes any depository institution, company, or institution-affiliated party that violates such a directive subject to civil money penalties pursuant to section 8(i)(2)(A). 12 U.S.C. 1818(i). The final rules adopt the proposed clarification that the failure of a depository institution to implement, in any material respect, a capital restoration plan, or the failure of a company having control of a depository institution to fulfill a

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guarantee that the company has given in connection with a capital plan accepted by the appropriate Federal banking agency, will subject responsible parties to civil money penalties. Commenters did not object to this proposal.

G. Capital Restoration Plans

1. Information Required

Section 38 requires an institution that is undercapitalized, significantly undercapitalized, or critically undercapitalized to submit a plan to the appropriate Federal banking agency to restore the institution's capital at least to the minimum capital levels required for adequately capitalized institutions. The statute requires that this capital restoration plan be submitted in writing and specify:

(1) The steps the institution will take to become adequately capitalized;

(2) The levels of capital the institution expects to attain in each year that the plan is in effect;

(3) How the institution will comply with the restrictions and requirements imposed on the institution under section 38;

(4) The types and levels of activities in which the institution will engage; and

(5) Any other information required by the appropriate Federal banking agency.

Section 38 provides that the appropriate Federal banking agency may not accept a capital restoration plan unless the plan:

(1) Contains the information required by statute;

(2) Is based on realistic assumptions and is likely to succeed in restoring the institution's capital; and

(3) Would not appreciably increase the risk (including credit risk, interest-rate risk, and other types of risk) to which the institution is exposed.

The agencies did not propose to require by regulation any additional information in a capital restoration plan submitted under section 38, and the commenters generally agreed that the agencies should not impose additional reporting requirements by regulation. The commenters argued that the agencies could require additional information in cases in which circumstances warranted.

2. Schedule for Submission and Review of Capital Plans

The agencies proposed adopting the schedule for submission and review of capital restoration plans that is generally established in the statute. This schedule provided an institution with 45 days to submit a capital restoration plan after the institution has received notice or been deemed to have notice that the institution is undercapitalized, significantly undercapitalized or critically undercapitalized.[11] The proposal permitted the appropriate Federal banking agency to change this period in individual cases, provided that the agency notified the institution that a different schedule had been adopted.

The proposed schedule also required the appropriate Federal banking agency to review each capital restoration plan within 60 days of submission of the plan unless the agency extends the time for review. The agencies would be required to provide written notice to the institution regarding whether the agency had approved or rejected the capital plan. The agency would also provide a copy of each acceptable capital restoration plan, or amendments thereto, to the FDIC within 45 days of accepting the plan.

The commenters addressing this proposal generally supported adopting the schedule provided in section 38, without revision. Two commenters argued that the agencies should be required to review capital restoration plans in less than 60 days.

The final rules adopt the schedule for filing and review of capital restoration plans as proposed. The agencies have determined not to shorten the review period for capital plans as a general matter because the longer period will permit the agencies to discuss revisions to the plan with the institution before the agency is required to take final action on the plan. The agencies expect, however, not to delay action on capital plans, and to act on these plans well within the regulatory schedule.

3. Failure to Submit or Implement an Acceptable Capital Plan

Section 38 provides that an undercapitalized institution that fails to submit or implement, in any material respect, an acceptable capital plan shall be subject to the same restrictions applicable to an institution that is significantly undercapitalized. In the event that the appropriate Federal banking agency has disapproved an institution's capital restoration plan, the proposal would require the institution to submit a new capital restoration plan within a time specified by the appropriate Federal banking agency. During the period following notice of such disapproval and prior to approval by the agency of a new or revised capital plan, the statute treats the institution in the same manner as a significantly undercapitalized institution. Institutions that fail to submit any capital restoration plan within the required period also are subject to the provisions applicable to significantly undercapitalized institutions. Included in these provisions is the statutory prohibition on payment by the institution of any bonus or raise to any senior executive officer.

Several commenters argued that the rule should be revised to permit an undercapitalized institution that had submitted its original capital restoration plan in good faith an opportunity to formulate and submit a revised capital plan before becoming subject to the provisions applicable to significantly undercapitalized institutions. Commenters expressed concern that rejection of the capital plan by the institution's appropriate agency, and corresponding treatment of the institution as significantly undercapitalized, pre-supposes an unwillingness on the part of the institution to devise and implement an acceptable capital plan. Commenters argued that a capital restoration plan may be found by an agency to be unacceptable for reasons that are unrelated to the willingness or ability of the institution to devise an acceptable capital plan. For example, commenters were concerned that a capital plan may be rejected because an institution was unaware that the appropriate agency expected the institution to take certain steps in addition to the steps proposed by the institution, or because developments may have occurred during the period that the plan is under review by the agency that were not reasonably foreseeable by the institution at the time the plan was submitted.

As an initial matter, the agencies believe that it is important that an undercapitalized institution discuss the development of its capital restoration plan with the appropriate banking agency during the period that the plan is being developed. The agencies have adopted the maximum time periods permitted by section 38 for the formal submission and review of a capital restoration plan in order to permit an opportunity for informal discussions between institutions and the appropriate agency. The adoption of a schedule for formal action does not, and is not intended to, preclude informal discussions between the institution and the appropriate agency regarding the elements of the plan prior to the time that the plan is formally submitted.

[11] As discussed above, an institution is deemed to have been notified of its capital category on the date that it is required to file its Call Report, the date that the institution receives its final report of examination or inspection, or the date that the appropriate federal banking agency notifies the institution of the institution's capital category (based on an adjustment to capital reported by the institution or on other information obtained by the agency).

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Further, as noted above, the agencies expect discussions to continue during the period that the agency reviews the plan. These discussions should eliminate the chances that a capital restoration plan will be rejected by the agency for a reason that is not anticipated by the institution.

In cases in which an undercapitalized institution nonetheless has failed to submit a capital restoration plan or a plan submitted by an institution is rejected by the appropriate agency, the statute provides that the institution is subject to the provisions applicable to significantly undercapitalized institutions. This treatment has two consequences under section 38.[12] First, the institution is subject to restrictions on its ability to pay bonuses or salary increases to the institution's senior executive officers. In this regard, section 38 specifically prohibits any institution that has failed to submit a capital restoration plan that is acceptable to its appropriate agency from paying any bonus or raise to its senior executive officers. The purpose of this restriction appears to be to prevent senior officers of an undercapitalized institution from receiving any increase in pay if the officers have not devised and submitted a capital restoration plan that the agency agrees will address the problems faced by the institution.

Second, the appropriate Federal banking agency for the institution is permitted to take, and must consider taking, a number of additional discretionary actions in connection with the institution. In determining whether to exercise its discretion to take additional supervisory actions, the agencies believe that they may consider the types of factors noted by the commenters, including events that have occurred after submission of the original plan, the efforts of management to devise a realistic and acceptable plan, and other factors.

In light of the statutory language and the ability of the agencies to consider the factors identified by commenters on a case-by-case basis in determining appropriate action that the agency should take, the agencies believe that it is appropriate to retain in the final rules the provision indicating that an undercapitalized institution is subject to the provisions applicable to significantly undercapitalized institutions in the event the institution has submitted a capital restoration plan that is rejected by the appropriate agency. Similarly, an undercapitalized institution that fails to implement, in any material respect, its capital restoration plan would immediately be subject to these same provisions upon the institution's failure to implement the plan.

4. Guarantee of Performance of Capital Restoration Plan

Section 38 provides that the appropriate agency may not accept a capital restoration plan submitted by an undercapitalized institution unless each company that controls the institution has guaranteed that the institution will comply with the plan until the institution has been adequately capitalized on average during each of four consecutive calendar quarters, and each such company has provided appropriate assurances of performance. This guarantee by any controlling company is independent of any liability of affiliates of the depository institution pursuant to the cross-guarantee provision of the FDI Act (12 U.S.C. 1815(e)).

The agencies proposed to implement the performance guarantee provision by providing that the agencies will not approve a capital restoration plan required to be submitted by an undercapitalized, significantly undercapitalized, or critically undercapitalized institution under section 38, unless each company that controls the institution submits a written guarantee of the plan.[13] The performance guarantee would include a commitment to take actions required by the capital plan, including, for example, assuring that competent management will be selected, restricting transactions between the institution and the controlling company, and discontinuing certain risky activities within the institution or an affiliate. This guarantee would also include assurances that the institution would fulfill any commitments to raise capital made in the plan. Each company that provides the financial guarantee would be jointly and severally liable for fulfillment of the guarantee, up to the statutory limit of liability. Failure of any company that controls an undercapitalized institution to provide the required guarantee causes the institution to become subject to the provisions of section 38 applicable to significantly undercapitalized institutions.

Section 38 also requires each company that controls an undercapitalized institution to provide adequate assurances that the institution will perform under its capital plan. Providing adequate assurances will include committing to take whatever steps are necessary to ensure that the capital restoration plan is fully implemented.

The agencies requested comment regarding whether it was appropriate to specify by regulation the types of performance assurances that would be required. In addition, the agencies proposed a number of clarifications to the capital guarantee in the original proposal.

Most of the commenters that addressed the guarantee provisions suggested that the agencies determine on a case-by-case basis, and not specify by regulation, the form of guarantee that would be acceptable and whether adequate assurances of performance had been given by companies that control an undercapitalized institution. At this time, the agencies agree with the commenters that the adequacy of a capital guarantee and of the assurances of performance should be determined on a case-by-case basis in connection with an agency's review of capital restoration plans, and not by regulation. This will provide the agencies and companies that control undercapitalized institutions with flexibility to devise guarantees that are appropriate for individual cases, and permit the agencies and the industry to gain experience with the types of assurances that are adequate. As the agencies and the industry gain experience in this area, the agencies will reconsider whether it is appropriate to establish regulatory requirements in this area.

The commenters generally did not object to the agencies' interpretation that each company that provides a performance guarantee under section 38 would be jointly and severally liable for fulfillment of the guarantee. However, several commenters requested clarification regarding whether companies that are intermediate shell holding companies would be permitted to fulfill their guarantee requirement by providing a certification that the parent of the intermediate companies would guarantee performance. Similarly, these commenters sought agency guidance regarding whether intermediate shell holding companies would be permitted to rely on the financial resources of the parent company or of a third party as adequate assurance of performance on the guarantee.

The agencies believe that a guarantee that is backed by the contractual pledge of resources of a parent company may, particularly in situations involving the ownership of an insured institution by a company through a wholly owned domestic shell holding company, satisfy

[12] As explained above, a significantly undercapitalized institution is subject to the same mandatory and discretionary provisions that apply to undercapitalized institutions.

[13] A capital restoration plan does not supersede an existing net worth maintenance agreement.

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the requirements of section 38. In other situations, a third party guarantee made by a party with adequate financial resources may be satisfactory for purposes of section 38. The agencies will consider the type of guarantee that would be appropriate in multi-tier holding companies on a case-by-case basis. The agencies will also consider on a case-by-case basis the type of guarantee that is necessary in the case of a parent holding company that is a shell company or has limited resources.

Section 38 limits the aggregate liability under the capital performance guarantee of all companies that control a given insured depository institution to the lesser of:

(1) An amount equal to 5 percent of the institution's total assets at the time the institution became undercapitalized; or

(2) The amount necessary (or that would be necessary) to bring the institution into compliance with all capital standards applicable with respect to such institution as of the time the institution fails to comply with its capital restoration plan.

In incorporating this provision into the regulation, the agencies proposed to adopt the same definition of total assets for purposes of computing the first component of the limit on liability as would be used in determining the capital category of the institution. As discussed above, the commenters unanimously favored using the same definition of capital terms to the extent possible in implementing section 38, and argued against the use of definitions that would require daily calculation of risk-weighted assets or capital. The final rules rely on existing definitions and capital calculation procedures in implementing the capital guarantee provisions.

The agencies also proposed to clarify that the second component of the limit on liability refers to the amount necessary to restore the capital of the institution to the applicable minimum capital levels as those levels were defined at the time that the institution initially failed to comply with its capital plan. The amount of a capital guarantee would not change if the minimum capital adequacy standards changed after the time the institution initially failed to comply with its capital restoration plan. [14] The commenters that addressed this issue favored this approach, and the agencies have adopted the proposal in the final rules.

[14] Any modification of the minimum capital requirement for savings associations, required by FIRREA's transition schedules, is not a change of the minimum capital adequacy requirements for purposes of section 38 and this part.

The final rules also include the agencies' proposal for implementing the statutory provision that limits the duration of a guarantee of a capital plan. Under the proposal, the appropriate Federal banking agency would provide notice to the company that the guarantee has expired once the depository institution has remained adequately capitalized for four consecutive calendar quarters. This approach permits the agency and the institution to verify that the limit of liability under the guarantee has expired.

The final rules adopt provisions that make clear that expiration of a guarantee or fulfillment of a guarantee given by a company in connection with one capital restoration plan does not relieve the company from the obligation to guarantee another capital restoration plan that may be required at a future date for the same institution if it again becomes undercapitalized. Similarly, the fact that a company has, at one time, fulfilled a guarantee by providing resources to an institution up to the statutory limit would not reduce the amount of any guarantee of a future capital plan for the same institution. Moreover, the provision or fulfillment by a company of a guarantee for one institution does not affect the obligation of that company to guarantee a capital plan in connection with any other insured depository institution. Commenters generally did not disagree with these provisions.

One commenter asked that a company that has performed on a guarantee of a capital plan be granted a two-year grace period before being required to guarantee another plan by the same institution. The agencies do not believe that the statute contemplates such an exception.

5. Priority in Bankruptcy

In the original proposal for comment, the agencies noted that the FDIC will have a priority claim in any bankruptcy proceedings of a holding company that has guaranteed an institution's compliance with a capital restoration plan. The FDIC's claim against a holding company's estate would have priority over the claims of unsecured creditors and is provided for in section 507(a)(8) of Title 11 of the United States Code, as amended by the Crime Control Act of 1990, Public Law 101–647, 104 Stat. 4789. Sections 365(o) and 523(a)(12) of Title 11 of the United States Code, as amended by the Crime Control Act of 1990, also provide special protections for the FDIC. The agencies did not receive any comment on this matter.

6. Submission of Plans by Reclassified Institutions

Section 38(g) provides that an institution that has been reclassified to a different capital category as a result of an agency determination that the institution is in an unsafe or unsound condition or is engaged in an unsafe or unsound practice must describe the steps the institution will take to address these deficiencies. The final rules reflect this statutory requirement.

Section 38(g) also provides that an institution is not required to submit a capital restoration plan if the institution nominally has adequate capital but has, because of its condition or practices, been made subject to provisions applicable to an undercapitalized institution. The agencies requested comment on whether it was appropriate to require by regulation that all adequately capitalized institutions that are subject to provisions as if the institution were undercapitalized file a plan describing the steps that would be required to address its deficiencies. The commenters strongly urged that this provision not be adopted in the regulation and that the agencies reserve authority to require plans on a case-by-case basis. The agencies agree that these plans may not always be appropriate and have determined to consider the need for these plans on a case-by-case basis as provided in section 38.

7. Revised Capital Restoration Plans

The agencies requested comment regarding whether the final rules should require in all cases that an insured depository institution that is operating under a capital restoration plan that has been approved by the appropriate Federal banking agency must submit an additional or a revised capital restoration plan if the institution's capital classification changes. Commenters generally believed that an inflexible rule would result in requiring an institution to file capital plans more frequently than necessary to address the institution's problems. On the other hand, commenters agreed that the agencies had discretion under section 38 to require a capital plan in individual cases as appropriate.

The final rules do not adopt a regulatory requirement that an institution file a new or revised capital restoration plan in the event that the institution's capital category changes. Instead, the agencies have adopted a provision in the final rules retaining discretion to determine on a case-by-case basis that an institution must

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submit a new or revised capital plan. Under the final rules, in the event that the agency determines that a new or revised plan must be submitted, the agency will provide notice to the institution.

H. Monitoring Undercapitalized Institutions.

Section 38 requires the agencies to monitor closely institutions that are undercapitalized, significantly undercapitalized, or critically undercapitalized. The agencies must also monitor compliance by these institutions with their capital restoration plans and with restrictions and requirements imposed under section 38. This monitoring will be carried out through review of the reports filed by the institution, examinations of the institution on an appropriate time schedule, and informal discussions with the institution regarding the steps that it is taking to improve its condition, develop and implement an acceptable capital restoration plan, and comply with applicable requirements.

As part of this monitoring program, the appropriate Federal agency will discuss with the institution any revisions that may need to be made by an institution to its capital plan. The appropriate agency also will discuss elimination of restrictions that are no longer needed as an institution successfully implements its capital plan and improves its financial condition. Once an institution has fulfilled its capital restoration plan and returned to at least the adequately capitalized category, directives issued pursuant to section 38 will be removed.

I. Other Matters

1. Definition of "Management Fee"

Section 38 of the FDI Act prohibits any institution from paying management fees to a controlling person if, following the payment of those fees, the institution would be undercapitalized. The agencies had proposed to define a management fee to be any payment for management services or advice, other than payments to individuals in their capacity as employees of the institution.

Commenters expressed concern that this definition could be interpreted to preclude payments for non-management services obtained from an affiliate, such as data processing services. In order to address this concern, one commenter, representing a group of insured institutions, suggested defining a management fee to be any payment made for the provision of management services or advice in connection with "supervisory, executive, managerial, or policymaking functions." The agencies believe that this formulation covers the types of fees identified by the statute without affecting fees paid for non-management services, which are not prohibited by the mandatory provisions of section 38.

The final rules generally adopt the language suggested by the commenter and define management fees to include any payment of money or provision of any other thing of value to a company or individual for the provision of management services or advice to the bank, or related overhead expenses, including payments related to supervisory, executive, managerial, or policymaking functions, other than compensation to an individual in the individual's capacity as an officer or employee of the bank. The definition does not include payments to a controlling person for such things as electronic data processing, trust activities, mortgage servicing, audit and accounting services, property management, or other similar service fees.

The agencies point out that while fees paid for nonmanagement services provided by an affiliate are not prohibited by the mandatory provisions of section 38, the agencies have discretion under several provisions of section 38 to restrict any fees paid to an affiliate by an undercapitalized institution or any transaction between the undercapitalized institution and an affiliate. The agencies also stress that all management fees and servicing fees paid by an insured institution to an affiliate are subject to the restrictions and requirements of sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c–1), regardless of the institution's capital category under section 38. Sections 23A and 23B require that services that are provided to an insured institution be provided on terms that are at least as favorable to the insured institution as would be available from a third party.

2. Definition of "Control" and "Controlling Person"

The agencies requested comment regarding the definition of "control," particularly whether an exception should be provided for persons that have acquired control of an institution in a fiduciary capacity or in satisfaction of a debt previously contracted (DPC). The word "control" is used in two provisions of the regulation: first, in the definition of controlling person, noted below, and second, in the requirement that for any capital restoration plan to be acceptable, the plan must be guaranteed by each company having control of the institution.

Section 38 does not define the term "control." Section 3 of the FDI Act, however, adopts the definition of "control" contained in section 2 of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1841(a)(2)). Under the BHC Act, a company controls an institution if the company owns or controls 25 percent or more of the voting securities of that institution, controls the board of directors of the institution; or exercises a controlling influence over the management or policies of the institution.

The BHC Act also provides exclusions for certain types of share ownership from the applicability of the control provisions. Section 2(a)(5)(A) of the BHC Act (12 U.S.C. 1841(a)(5)(A)) states that a bank or company is not deemed to be a bank holding company by virtue of its ownership or control of shares in a fiduciary capacity, provided that the bank or company does not retain sole right to vote the shares. Additionally, section 2(a)(5)(D) of the BHC Act (12 U.S.C. 1841(a)(5)(D)) permits a company to hold shares of a depository institution acquired DPC without being deemed to be a bank holding company, provided that the company disposes of the shares within two years (with the possibility of three one-year extensions).

The proposed rules noted that the FDI Act also contains a DPC exception. Section 5 of the Act (12 U.S.C. 1815), addresses the liability of commonly controlled depository institutions for "cross-guarantee" claims. Section 5(e)(7) of the FDI Act (12 U.S.C. 1815(e) (7)) contains an exception for the acquisition by an insured depository institution of shares of another depository institution in satisfaction of a debt previously contracted. That exception is conditioned on the requirement that all transactions between the controlling institution or any affiliate of the controlling institution and the subsidiary institution comply with the restrictions contained in sections 23A and 23B of the Federal Reserve Act.

The agencies requested comment on whether it would be appropriate under section 38 to provide, by regulation, an exception from the definition of "control" for shares held in a fiduciary capacity or for shares acquired DPC. The agencies also requested comment on whether, assuming there were an exception for shares acquired DPC, the exception should be subject to the conditions established in the FDI Act regarding compliance with sections 23A and 23B.

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The agencies received 18 comment letters on this matter. All 18 comment letters supported the adoption of a definition of "control" similar to that found presently in the BHC Act. Seventeen comment letters also supported the adoption of fiduciary ownership and DPC exceptions from the definition of "control". Commenters strongly supported adopting these exceptions and argued that without these exceptions companies would be unlikely to hold stock from an insured institution in a fiduciary capacity or accept such stock as collateral for a loan because of the potential liability under section 38. Seven comment letters supported the inclusion of conditions similar to those contained in section 5(e)(7) of the FDI Act in the DPC exception, with one comment letter opposed.

The agencies have included in the final rules implementing section 38 a definition of the term "control" identical to that provided in section 2 of the BHC Act and an exception from that definition for shares held in a fiduciary capacity and for shares acquired DPC. Similar to section 2(a)(5)(A) of the BHC Act, the fiduciary exception is premised on the condition that the bank or company holding the shares not retain the sole right to vote the shares. The DPC exception in the final rule parallels section 2(a)(5)(D) of the BHC Act in that the shares held DPC must be disposed of within two years, with the possibility of three one-year extensions. The agencies did not consider it necessary to include conditions similar to those contained in the DPC exception to section 5 of the FDI Act (12 U.S.C. 1815(e)(7)) in the final rule.

Qualification for an exemption from the definition of control, however, does not exempt the depository institution whose shares are held by another company or depository institution from the provisions of section 38. Whether or not it is "controlled" by another entity, a depository institution whose stock is held DPC or in a fiduciary capacity will still be subject to all relevant provisions of section 38 in accordance with its capital category. For example, an undercapitalized institution whose stock is held DPC may not pay dividends.

The final rules add a definition of the term "controlling person." The term "controlling person" is defined as any person having control of an insured depository institution and any company controlled by that person. Thus, the prohibition on payment of management fees covers payment to any company, including a consulting firm, owned by the principal shareholder of an institution, and any servicing company owned by a bank holding company.

3. Restrictions on Advertising

The proposed rule limited an insured depository institution's use of its capital category for any purpose, except when permitted by the appropriate Federal banking agency or otherwise required by law. This provision was intended to restrict the ability of insured depository institutions to advertise their capital category.

The agencies received eleven comments in support of this limitation on use of the capital category. Twelve commenters objected and urged that financial institutions be allowed to advertise their capital category.

Some commenters expressed concern about the practicality of such a prohibition given that disclosure of the category may be required for purposes of risk-based deposit insurance premiums, brokered deposits, and interbank liabilities. Disclosure may also be necessary in securities filings.

The agencies recognize that disclosure may be appropriate under some circumstances. The prompt corrective action framework in section 38 was designed, however, to be a supervisory tool, not a marketing vehicle. The agencies have long held that capital levels are a lagging indicator of problems in financial institutions. An advertisement that cites a financial institution's capital category under section 38 could be misleading to the general public. Depositors, investors and other affected persons could improperly view the capital category designation as the regulator's definitive assessment of the insured depository institution's true financial condition.

Taking account of the concerns expressed by the commenters, the final rule has narrowed the disclosure restriction to prohibit the advertising of the capital category assigned to an institution pursuant to section 38. The final rule does not restrict advertising of the institution's capital levels or financial condition. The institution may not, however, describe itself in an advertisement or in promotional material as falling within the well capitalized category, as that category is defined by the Federal banking agencies pursuant to section 38. Nor may the institution advertise that its appropriate Federal banking agency has determined it to be well capitalized.

4. Applicability of Capital Categories to Bank Holding Companies and Savings and Loan Holding Companies

Section 38 applies capital-based prompt corrective action to insured depository institutions but not to holding companies that control such institutions. The commenters strongly urged the Federal Reserve Board and the OTS not to impose the framework of section 38 to bank holding companies and to savings and loan holding companies. Several commenters argued that the enactment of section 38 provided the agencies with an opportunity to eliminate the capital adequacy standards that are currently applicable to bank holding companies and savings and loan holding companies.

The Board and the OTS have determined not to apply section 38 to bank holding companies and savings and loan holding companies. The statute, by its terms, applies only to insured depository institutions, and Congress has provided no indication that it intended the framework to be extended. The agencies also have authority under a number of other statutory provisions to supervise the activities and financial condition of holding companies.

The agencies note, however, that, while the complete supervisory framework of section 38 does not govern holding companies, various provisions of section 38 apply to companies that control insured depository institutions. These provisions, including the provisions regarding guarantee of a capital restoration plan, appear to apply to holding companies regardless of the capital level of those holding companies. The Federal Reserve Board intends to consult with the Federal banking agency for each insured depository institution subsidiary of a bank holding company to monitor supervisory actions required under section 38, and, in the supervision of the holding company, to take appropriate action at the holding company level based on an assessment of these developments. In supervising savings and loan holding companies, the OTS will concentrate on ensuring that subsidiary savings associations are well managed and well capitalized and that transactions and relationships between savings associations and their holding companies satisfy fiduciary requirements and do not negatively affect the safety and soundness of the subsidiary associations. OTS will supervise holding companies in a manner consistent with the effectiveness of supervisory actions required under section 38 imposed upon subsidiary associations.

5. Restrictions on Activities of Critically Undercapitalized Institutions

Section 38(i) of the FDI Act provides that the FDIC must, by regulation or

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order, restrict the activities of critically undercapitalized institutions. The activities that must be restricted are described above. FDICIA does not provide specific guidance on how to interpret and implement each of the restrictive provisions of section 38(i). Consequently, the FDIC considered a number of options.

The prohibition on entering into "any material transaction other than in the usual course of business" can be interpreted in a general fashion relying on outstanding case law in the area of securities disclosures. The concept of materiality also could be defined from an accounting perspective by establishing specific limits for determining materiality. For example, the FDIC could, by regulation, require that any prospective transaction other than one that is in the usual course of business that results or could result in a 5 percent change in an institution's tangible equity capital account or net income account would automatically be considered a material transaction requiring the FDIC's prior approval. Other transactions could be defined as material on a case by case basis. The FDIC solicited comment on how to define the terms "material" and "usual course of business" as well as what specific guidance, if any, should be provided by the FDIC to the banking industry.

The FDIC received two comments on the materiality issue. One respondent suggested the definition be based on market capitalization as opposed to a percentage based on equity capital. The range suggested was between 5 and 10 percent. The other respondent suggested that the denominator for defining a material transaction be based on 10 percent of total assets.

After consideration of the above comments, the FDIC has decided to define a material transaction on a case-by-case basis. The FDIC believes that defining a material transaction using a fixed percentage of capital or assets could be arbitrary and exclude those transactions that initially may be de minimus in amount or not easily subjected to a quantifiable measure but "material" in substance such as a proposal to engage in a new service-oriented activity. A fixed measurement also could be inconsistent with the statutory requirement that a material transaction includes those activities where the institution would have to notify its appropriate Federal banking agency.

The FDIC did not receive any comments on how to apply the phrase "usual course of business" or what specific guidance, if any, to provide to the banking industry. The FDIC intends to interpret this phrase to mean any activity currently engaged in by the specific institution. Therefore, any new activity not currently exercised by the specific institution, though permissible and approved by the appropriate regulator(s), would require the FDIC's prior written approval. For example, a critically undercapitalized institution that wishes to engage for the first time in commercial real estate lending and to establish a new commercial real estate loan department would be required to obtain the FDIC's prior written approval under this section.

The FDIC recognizes that the types of activities considered "usual" for a particular institution are contingent on its size, location, management expertise, business strategy, etc. Consequently, what may be "usual" for a large urban institution may not be "usual" for a smaller rural institution and vice versa. The FDIC believes that this definition of new activity is consistent with the statutory intent that troubled institutions should focus their attention on their existing problems and existing lines of business.

The FDIC proposed to define the term "highly leveraged transaction" by utilizing the interagency definition published in the **Federal Register** (57 FR 5040, February 11, 1992). Due to the uncertainty over whether the HLT definition will remain in effect, the FDIC has decided to adopt in the final rule an abbreviated definition for HLTs that will apply to critically undercapitalized institutions. The FDIC also intends to rely on existing generally accepted accounting principles when interpreting the restriction on making any "material change in accounting methods."

Section 39(c) of the FDI Act requires the Federal banking agencies to prescribe standards for determining when compensation paid to employees, directors and principal shareholders of insured depository institutions is excessive. An advance notice of proposed rulemaking was recently published in the **Federal Register** (52 FR 31336, July 15, 1992). The FDIC intends to interpret the restrictive provision in section 38(i)(2)(F) involving the payment of excessive compensation or bonuses in a manner that is consistent with the FDIC's actions in fulfilling the requirements of section 39(c) of the FDI Act. In the interim, the FDIC intends to enforce section 38(i) by requiring prior written approval of any change in the institution's compensation of any of its executive officers (as defined in Federal Regulation O (12 CFR part 215), directors and principal shareholders and will consider existing compensation levels on a case-by-case basis.

The provision that restricts "paying interest on new or renewed liabilities at a rate that would increase the institution's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest on insured deposits in the institution's normal market areas" contains terms that are similar to those mandated by section 301 of FDICIA and the revisions of § 337.6 of the FDIC's regulations (12 CFR 337.6) as recently implemented by the FDIC. Specifically, the FDIC intends to interpret the phrase "significantly exceeding the prevailing rates" the same as defined in § 337.6. The prevailing effective yields of interest are the effective yields on insured deposits of comparable maturities offered by other insured depository institutions in the market area in which deposits are being solicited. A market area is any readily defined geographic area in which the rates offered by any one insured depository institution soliciting deposits in the area may affect the rates offered by other institutions soliciting deposits in the same area.

6. Application of Prompt Corrective Action to Insured Branches

Section 38(a)(2) of the FDI Act, as added by section 131 of FDICIA, provides that each appropriate Federal banking agency and the FDIC (acting in the FDIC's capacity as the insurer of depository institutions) shall take prompt corrective action to resolve the problems of insured depository institutions.

Section 3(c)(2) of the FDI Act defines the term "insured depository institution" as any bank or savings association the deposits of which are insured by the FDIC pursuant to the FDI Act. 12 U.S.C. 1813(c)(2). The term "bank" is defined, in section 3(a)(1) of the FDI Act, to include, *inter alia*, any "insured branch." 12 U.S.C. 1813(a)(1). Section 3(s)(3) defines the term "insured branch" to mean any branch (as defined in section 1(b)(3) of the International Banking Act of 1978) of a foreign bank any deposits in which are insured pursuant to the FDI Act. 12 U.S.C. 1813(s)(3).

The plain language of these statutory provisions requires the application of the prompt corrective action provisions to insured branches of foreign banks, including insured federal branches. Insured branches, however, are not required to maintain minimum capital levels under the FDIC's capital maintenance regulations, 12 CFR part 325. In fact, they are expressly excluded

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from the definition of "insured depository institution" which is used in the FDIC's capital maintenance regulations. 12 CFR 325.2(f). Insured branches, however, are required to maintain a pledge of assets, pursuant to 12 CFR 346.19, and a certain volume of eligible assets, pursuant to 12 CFR 346.20.

Insured federal branches, likewise, are not required to maintain minimum capital levels under the OCC's capital maintenance regulations, 12 CFR part 3. See 50 FR 10215, March 14, 1985. In addition to the asset pledge and asset maintenance requirements to which all insured branches are subject, all federal branches are required by section 4 of the International Banking Act of 1978 (12 U.S.C. 3102(g)(2)) to establish capital equivalency deposits which generally must equal at least 5 percent of the branch's third party liabilities. Federal branches also may be required by the OCC to maintain a certain quantity of specified assets in the states in which they operate.

In an effort to promote competitive equality between insured federal and state branches of foreign banks, the OCC and the FDIC proposed a uniform definition of capital categories for all insured branches of foreign banks based upon the FDIC's asset pledge and asset maintenance requirements which apply to all insured branches.

The OCC and the FDIC recognize that the eligible assets and, more particularly, the pledge of assets are not perfect substitutes for capital. Nonetheless, the FDIC has long taken the position that the asset maintenance requirement is analogous to a domestic bank's required capital. Therefore, the OCC and the FDIC have decided to utilize FDIC's regulations governing the pledge of assets and the level of eligible assets to determine an insured branch's capital category.

For prompt corrective action purposes, an insured federal branch will be deemed:

"Well capitalized" if it:

1. Maintains the pledge of assets required under 12 CFR 346.19; and

2. Maintains the eligible assets prescribed under 12 CFR 346.20 at 108 percent or more of the preceding quarter's average book value of the insured branch's third-party liabilities; and

3. Has not received written notification from (1) the OCC to increase its capital equivalency deposit pursuant to 12 CFR 28.6(a), or to comply with the asset maintenance requirements pursuant to 12 CFR 28.9 or (2) the FDIC to pledge additional assets pursuant to 12 CFR 346.19 or to maintain a higher ratio of eligible assets pursuant to 12 CFR 346.20.

"Adequately capitalized" if it:

1. Maintains the pledge of assets required under 12 CFR 346.19;

2. Maintains the eligible assets prescribed under 12 CFR 346.20 at 106 percent or more of the preceding quarter's average book value of the insured branch's third-party liabilities; and

3. Does not meet the definition of a "well capitalized" insured branch.

"Undercapitalized" if it:

1. Fails to maintain the pledge of assets required under 12 CFR 346.19; or

2. Fails to maintain the eligible assets prescribed under 12 CFR 346.20 at 106 percent or more of the preceding quarter's average book value of the insured branch's third-party liabilities.

"Significantly undercapitalized" if it fails to maintain the eligible assets prescribed under 12 CFR 346.20 at 104 percent or more of the preceding quarter's average book value of the insured branch's third-party liabilities.

"Critically undercapitalized" if it fails to maintain the eligible assets prescribed under 12 CFR 346.20 at 102 percent or more of the preceding quarter's average book value of the insured branch's third-party liabilities.

Section 38 of the FDI Act enumerates the corrective measures that the appropriate Federal banking agency may or must take against, and what restrictions apply to, institutions in each of the five capital categories. Some of the prescribed measures and applicable restrictions may not be practical or appropriate in dealing with insured branches of foreign banks.

Therefore, it is the intent of the OCC and the FDIC to apply to insured branches as many of the prompt corrective measures and restrictions as practical and appropriate, given the unique characteristics of insured branches.

Several respondents expressed the view that the prompt corrective action provisions in section 38 of the FDI Act should apply to insured branches of foreign banks and that the capital levels should be comparable with those for domestic banks. The FDIC and OCC, as the primary federal regulators of insured branches, concur with this approach. As a result, the prompt corrective action rules of the FDIC and OCC intend to accomplish this objective by using the asset pledge and asset maintenance tests noted above for purposes of determining an insured branch's capital category.

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, it is hereby certified that these final rules will not have a significant impact on a substantial number of small entities.

The final rules impose the minimum burdens necessary to implement the prompt corrective action provisions of section 131 of FDICIA for all insured depository institutions, regardless of size. The regulation requires each insured depository institution to monitor its capital levels and to report to the appropriate Federal banking agency any material event that would cause the institution to be classified within a lower capital category. In addition, the final rules require an institution that becomes undercapitalized, significantly undercapitalized, or critically undercapitalized to submit a capital restoration plan.

The filing of the capital plan is a requirement imposed by statute and occurs only when an institution initially becomes undercapitalized, significantly undercapitalized, or critically undercapitalized. In establishing a mechanism for gathering sufficient information to determine the appropriate capital category for each insured depository institution, the Federal banking agencies have attempted to reduce the burden imposed on such institutions by relying primarily on the Call Report that must already be filed and on reports of examination that would otherwise take place. No additional regular reporting requirement has been imposed.

Executive Order 12291

The OCC and OTS have determined that these final rules are not major regulations as defined in Executive Order 12291. These final rules implements section 131 of FDICIA, which established a new statutory framework for resolving the problems of insured depository institutions at the least long-term cost to the FDIC.

List of Subjects

12 CFR Part 6

Banks, Banking, Capital adequacy, National banks.

12 CFR Part 19

Administrative practice and procedure, Crime, Dismissals, Investigations, National banks, Penalties, Reclassification, Securities.

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business

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information, Currency, Federal Reserve System, Reporting and recordkeeping requirements, Securities.

12 CFR Part 263

Administrative practice and procedure, Federal Reserve System.

12 CFR Part 308

Administrative practice and procedure, claims, equal access to justice, lawyers, penalties.

12 CFR Part 325

Bank deposit insurance, Banks, Banking, Capital adequacy, Reporting and recordkeeping requirements, State nonmember banks, Savings associations.

12 CFR Part 565

Administrative practice and procedure, Capital, Savings associations.

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 263

For the reasons outlined above, the Board of Governors amends 12 CFR parts 208 and 263 as set forth below:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM

1. The authority citation for 12 CFR part 208 is revised to read as follows:

Authority: Secs. 9, 11(a), 11(c), 19, 21, 25 and 25(a) of the Federal Reserve Act, as amended (12 U.S.C. 321–338, 248(a), 248(c), 461, 481–486, 601, and 611, respectively); secs. 4, 13(j) and 38 of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1814, 1823(j), and 1831o, respectively); sec. 7(a) of the International Banking Act of 1978 (12 U.S.C. 3105); secs. 907–910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3906–3909); secs. 2, 12(b), 12(g), 12(i), 15B(c) (5), 17, 17A, and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78b, 781(b), 1781(g), 781(i), 78o–4(c) (5), 78q, 78q–1, and 78w, respectively); sec. 5155 of the Revised Statutes (12 U.S.C. 36) as amended by the McFadden Act of 1927; and secs. 1101–1122 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (12 U.S.C. 3310 and 3331–3351).

Subpart A—General Provisions

2. The undesignated centerheading preceding § 208.1 is removed, §§ 208.1 through 208.19 are designated as subpart A to part 208, and the subpart A heading is added to read as set forth above.

3. Subpart B, comprising §§ 208.30 through 208.35, is added to part 208 to read as follows:

Subpart B—Prompt Corrective Action

Sec.

208.30 Authority, purpose, scope, other supervisory authority, and disclosure of capital categories.
208.31 Definitions.
208.32 Notice of capital category.
208.33 Capital measures and capital category definitions.
208.34 Capital restoration plans.
208.35 Mandatory and discretionary supervisory actions under section 38.

Subpart B—Prompt Corrective Action

§ 208.30 Authority, purpose, scope, other supervisory authority, and disclosure of capital categories.

(a) *Authority.* This subpart is issued by the Board of Governors of the Federal Reserve System (Board) pursuant to section 38 (section 38) of the Federal Deposit Insurance Act (FDI Act) as added by section 131 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (Pub. L. 102–242, 105 Stat. 2236 (1991)) (12 U.S.C. 1831o.).

(b) *Purpose.* Section 38 of the FDI Act establishes a framework of supervisory actions for insured depository institutions that are not adequately capitalized. The principal purpose of this subpart is to define, for state member banks, the capital measures and capital levels that are used for determining the supervisory actions authorized under section 38 of the FDI Act. This subpart also establishes procedures for submission and review of capital restoration plans and for issuance and review of directives and orders pursuant to section 38.

(c) *Scope.* This subpart implements the provisions of section 38 of the FDI Act as they apply to state member banks. Certain of these provisions also apply to officers, directors and employees of state member banks. Other provisions apply to any company that controls a state member bank and to the affiliates of a state member bank.

(d) *Other supervisory authority.* Neither section 38 nor this subpart in any way limits the authority of the Board under any other provision of law to take supervisory actions to address unsafe or unsound practices, deficient capital levels, violations of law, unsafe or unsound conditions, or other practices. Action under section 38 of the FDI Act and this subpart may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the Board, including issuance of cease and desist orders, capital directives, approval or denial of applications or notices, assessment of civil money penalties, or any other actions authorized by law.

(e) *Disclosure of capital categories.* The assignment of a bank under this subpart within a particular capital category is for purposes of implementing and applying the provisions of section 38. Unless permitted by the Board or otherwise required by law, no bank may state in any advertisement or promotional material its capital category under this subpart or that the Board or any other Federal banking agency has assigned the bank to a particular capital category.

§ 208.31 Definitions.

For purposes of this subpart, except as modified in this section or unless the context otherwise requires, the terms used have the same meanings as set forth in section 38 and section 3 of the FDI Act.

(a) (1) *Control* has the same meaning assigned to it in section 2 of the Bank Holding Company Act (12 U.S.C. 1841), and the term "controlled" shall be construed consistently with the term "control."

(2) *Exclusion for fiduciary ownership.* No insured depository institution or company controls another insured depository institution or company by virtue of its ownership or control of shares in a fiduciary capacity. Shares shall not be deemed to have been acquired in a fiduciary capacity if the acquiring insured depository institution or company has sole discretionary authority to exercise voting rights with respect thereto.

(3) *Exclusion for debts previously contracted.* No insured depository institution or company controls another insured depository institution or company by virtue of its ownership or control of shares acquired in securing or collecting a debt previously contracted in good faith, until two years after the date of acquisition. The two-year period may be extended at the discretion of the appropriate Federal banking agency for up to three one-year periods.

(b) *Controlling person* means any person having control of an insured depository institution and any company controlled by that person.

(c) *Leverage ratio* means the ratio of Tier 1 capital to average total consolidated assets, as calculated in accordance with the Board's Capital Adequacy Guidelines for State Member Banks: Tier 1 Leverage Measure (appendix B to part 208).

(d) *Management fee* means any payment of money or provision of any other thing of value to a company or individual for the provision of management services or advice to the bank or related overhead expenses,

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including payments related to supervisory, executive, managerial, or policymaking functions, other than compensation to an individual in the individual's capacity as an officer or employee of the bank.

(e) *Risk-weighted assets* means total weighted risk assets, as calculated in accordance with the Board's Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure (appendix A to part 208).

(f) *Tangible equity* means the amount of core capital elements in the Board's Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure (appendix A to part 208), plus the amount of outstanding cumulative perpetual preferred stock (including related surplus), minus all intangible assets except purchased mortgage servicing rights to the extent that the Board determines pursuant to section 475 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 1828 note) that purchased mortgage servicing rights may be included in calculating the bank's Tier 1 capital.

(g) *Tier 1 capital* means the amount of Tier 1 capital as defined in the Board's Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure (appendix A to part 208).

(h) *Tier 1 risk-based capital ratio* means the ratio of Tier 1 capital to weighted risk assets, as calculated in accordance with the Board's Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure (appendix A to part 208).

(i) *Total assets* means quarterly average total assets as reported in a bank's Report of Condition and Income (Call Report), minus intangible assets as provided in the definition of tangible equity.

(j) *Total risk-based capital ratio* means the ratio of qualifying total capital to weighted risk assets, as calculated in accordance with the Board's Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure (appendix A to part 208).

§ 208.32 Notice of capital category.

(a) *Effective date of determination of capital category.* A state member bank shall be deemed to be within a given capital category for purposes of section 38 of the FDI Act and this subpart as of the date the bank is notified of, or is deemed to have notice of, its capital category, pursuant to paragraph (b) of this section.

(b) *Notice of capital category.* A state member bank shall be deemed to have been notified of its capital levels and its capital category as of the most recent date:

(1) A Report of Condition and Income (Call Report) is required to be filed with the Board;

(2) A final report of examination is delivered to the bank; or

(3) Written notice is provided by the Board to the bank of its capital category for purposes of section 38 of the FDI Act and this subpart or that the bank's capital category has changed as provided in paragraph (c) of this section or § 208.33(c).

(c) *Adjustments to reported capital levels and capital category.—(1) Notice of adjustment by bank.* A state member bank shall provide the Board with written notice that an adjustment to the bank's capital category may have occurred no later than 15 calendar days following the date that any material event has occurred that would cause the bank to be placed in a lower capital category from the category assigned to the bank for purposes of section 38 and this subpart on the basis of the bank's most recent Call Report or report of examination.

(2) *Determination by the Board to change capital category.* After receiving notice pursuant to paragraph (c)(1) of this section, the Board shall determine whether to change the capital category of the bank and shall notify the bank of the Board's determination.

§ 208.33 Capital measures and capital category definitions.

(a) *Capital measures.* For purposes of section 38 and this subpart, the relevant capital measures shall be:

(1) The total risk-based capital ratio;

(2) The Tier 1 risk-based capital ratio; and

(3) The leverage ratio.

(b) *Capital categories.* For purposes of section 38 and this subpart, a state member bank shall be deemed to be:

(1) "Well capitalized" if the bank:

(i) Has a total risk-based capital ratio of 10.0 percent or greater; and

(ii) Has a Tier 1 risk-based capital ratio of 6.0 percent or greater; and

(iii) Has a leverage ratio of 5.0 percent or greater; and

(iv) Is not subject to any written agreement, order, capital directive, or prompt corrective action directive issued by the Board pursuant to section 8 of the FDI Act, the International Lending Supervision Act of 1983 (12 U.S.C. 3907), or section 38 of the FDI Act, or any regulation thereunder, to meet and maintain a specific capital level for any capital measure.

(2) "Adequately capitalized" if the bank:

(i) Has a total risk-based capital ratio of 8.0 percent or greater; and

(ii) Has a Tier 1 risk-based capital ratio of 4.0 percent or greater; and

(iii) Has—

(A) A leverage ratio of 4.0 percent or greater, or

(B) A leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMEL rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth; and

(iv) Does not meet the definition of a "well capitalized" bank.

(3) "Undercapitalized" if the bank:

(i) Has a total risk-based capital ratio that is less than 8.0 percent; or

(ii) Has a Tier 1 risk-based capital ratio that is less than 4.0 percent; or

(iii) (A) Except as provided in clause (B), has a leverage ratio that is less than 4.0 percent; or

(B) Has a leverage ratio that is less than 3.0 percent, if the bank is rated composite 1 under the CAMEL rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth.

(4) "Significantly undercapitalized" if the bank has—

(i) A total risk-based capital ratio that is less than 6.0 percent; or

(ii) A Tier 1 risk-based capital ratio that is less than 3.0 percent; or

(iii) A leverage ratio that is less than 3.0 percent.

(5) "Critically undercapitalized" if the bank has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent.

(c) *Reclassification based on supervisory criteria other than capital.* The Board may reclassify a well capitalized state member bank as adequately capitalized and may require an adequately capitalized or an undercapitalized state member bank to comply with certain mandatory or discretionary supervisory actions as if the bank were in the next lower capital category (except that the Board may not reclassify a significantly undercapitalized bank as critically undercapitalized) (each of these actions are hereinafter referred to generally as "reclassifications") in the following circumstances:

(1) *Unsafe or unsound condition.* The Board has determined, after notice and opportunity for hearing pursuant to § 263.203 of this chapter, that the bank is in unsafe or unsound condition; or

(2) *Unsafe or unsound practice.* The Board has determined, after notice and opportunity for hearing pursuant to § 263.203 of this chapter, that, in the most recent examination of the bank,

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

§ 208.34 Capital restoration plans.

(a) *Schedule for filing plan*—(1) *In general.* A state member bank shall file a written capital restoration plan with the appropriate Reserve Bank within 45 days of the date that the bank receives notice or is deemed to have notice that the bank is undercapitalized, significantly undercapitalized, or critically undercapitalized, unless the Board notifies the bank in writing that the plan is to be filed within a different period. An adequately capitalized bank that has been required pursuant to § 208.33(c) to comply with supervisory actions as if the bank were undercapitalized is not required to submit a capital restoration plan solely by virtue of the reclassification.

(2) *Additional capital restoration plans.* Notwithstanding paragraph (a)(1) of this section, a bank that has already submitted and is operating under a capital restoration plan approved under section 38 and this subpart is not required to submit an additional capital restoration plan based on a revised calculation of its capital measures or a reclassification of the institution under § 208.33(c) unless the Board notifies the bank that it must submit a new or revised capital plan. A bank that is notified that it must submit a new or revised capital restoration plan shall file the plan in writing with the appropriate Reserve Bank within 45 days of receiving such notice, unless the Board notifies the bank in writing that the plan is to be filed within a different period.

(b) *Contents of plan.* All financial data submitted in connection with a capital restoration plan shall be prepared in accordance with the instructions provided on the Call Report, unless the Board instructs otherwise. The capital restoration plan shall include all of the information required to be filed under section 38(e)(2) of the FDI Act. A bank that is required to submit a capital restoration plan as the result of a reclassification of the bank pursuant to § 208.33(c) shall include a description of the steps the bank will take to correct the unsafe or unsound condition or practice. No plan shall be accepted unless it includes any performance guarantee described in section 38(e)(2)(C) of that Act by each company that controls the bank.

(c) *Review of capital restoration plans.* Within 60 days after receiving a capital restoration plan under this subpart, the Board shall provide written notice to the bank of whether the plan has been approved. The Board may extend the time within which notice regarding approval of a plan shall be provided.

(d) *Disapproval of capital plan.* If a capital restoration plan is not approved by the Board, the bank shall submit a revised capital restoration plan within the time specified by the Board. Upon receiving notice that its capital restoration plan has not been approved, any undercapitalized state member bank (as defined in § 208.33(b)(3)) shall be subject to all of the provisions of section 38 and this subpart applicable to significantly undercapitalized institutions. These provisions shall be applicable until such time as a new or revised capital restoration plan submitted by the bank has been approved by the Board.

(e) *Failure to submit capital restoration plan.* A state member bank that is undercapitalized (as defined in § 208.33(b)(3)) and that fails to submit a written capital restoration plan within the period provided in this section shall, upon the expiration of that period, be subject to all of the provisions of section 38 and this subpart applicable to significantly undercapitalized institutions.

(f) *Failure to implement capital restoration plan.* Any undercapitalized state member bank that fails in any material respect to implement a capital restoration plan shall be subject to all of the provisions of section 38 and this subpart applicable to significantly undercapitalized institutions.

(g) *Amendment of capital plan.* A bank that has filed an approved capital restoration plan may, after prior written notice to and approval by the Board, amend the plan to reflect a change in circumstance. Until such time as a proposed amendment has been approved, the bank shall implement the capital restoration plan as approved prior to the proposed amendment.

(h) *Notice to FDIC.* Within 45 days of the effective date of Board approval of a capital restoration plan, or any amendment to a capital restoration plan, the Board shall provide a copy of the plan or amendment to the Federal Deposit Insurance Corporation.

(i) *Performance guarantee by companies that control a bank—(1) Limitation on Liability*—(i) *Amount limitation.* The aggregate liability under the guarantee provided under section 38 and this subpart for all companies that control a specific state member bank that is required to submit a capital restoration plan under this subpart shall be limited to the lesser of:

(A) An amount equal to 5.0 percent of the bank's total assets at the time the bank was notified or deemed to have notice that the bank was undercapitalized; or

(B) The amount necessary to restore the relevant capital measures of the bank to the levels required for the bank to be classified as adequately capitalized, as those capital measures and levels are defined at the time that the bank initially fails to comply with a capital restoration plan under this subpart.

(ii) *Limit on duration.* The guarantee and limit of liability under section 38 and this subpart shall expire after the Board notifies the bank that it has remained adequately capitalized for each of four consecutive calendar quarters. The expiration or fulfillment by a company of a guarantee of a capital restoration plan shall not limit the liability of the company under any guarantee required or provided in connection with any capital restoration plan filed by the same bank after expiration of the first guarantee.

(iii) *Collection on guarantee.* Each company that controls a given bank shall be jointly and severally liable for the guarantee for such bank as required under section 38 and this subpart, and the Board may require and collect payment of the full amount of that guarantee from any or all of the companies issuing the guarantee.

(2) *Failure to provide guarantee.* In the event that a bank that is controlled by any company submits a capital restoration plan that does not contain the guarantee required under section 38(e) (2) of the FDI Act, the bank shall, upon submission of the plan, be subject to the provisions of section 38 and this subpart that are applicable to banks that have not submitted an acceptable capital restoration plan.

(3) *Failure to perform guarantee.* Failure by any company that controls a bank to perform fully its guarantee of any capital plan shall constitute a material failure to implement the plan for purposes of section 38(f) of the FDI Act. Upon such failure, the bank shall be subject to the provisions of section 38 and this subpart that are applicable to banks that have failed in a material respect to implement a capital restoration plan.

§ 208.35 Mandatory and discretionary supervisory actions under section 38.

(a) *Mandatory supervisory actions*—(1) *Provisions applicable to all banks.* All state member banks are subject to the restrictions contained in section 38(d) of the FDI Act on payment of capital distributions and management fees.

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(2) *Provisions applicable to undercapitalized, significantly undercapitalized, and critically undercapitalized banks.* Immediately upon receiving notice or being deemed to have notice, as provided in section § 208.32 or section § 208.34 of this subpart, that the bank is undercapitalized, significantly undercapitalized, or critically undercapitalized, the bank shall become subject to the provisions of section 38 of the FDI Act:

(i) Restricting payment of capital distributions and management fees (section 38(d));

(ii) Requiring that the Board monitor the condition of the bank (section 38(e)(1));

(iii) Requiring submission of a capital restoration plan within the schedule established in this subpart (section 38(e)(2));

(iv) Restricting the growth of the bank's assets (section 38(e)(3)); and

(v) Requiring prior approval of certain expansion proposals (section 3(e)(4)).

(3) *Additional provisions applicable to significantly undercapitalized, and critically undercapitalized banks.* In addition to the provisions of section 38 of the FDI Act described in paragraph (a)(2) of this section, immediately upon receiving notice or being deemed to have notice, as provided in § 208.32 or § 208.34 of this subpart, that the bank is significantly undercapitalized, or critically undercapitalized, or that the bank is subject to the provisions applicable to institutions that are significantly undercapitalized because the bank failed to submit or implement in any material respect an acceptable capital restoration plan, the bank shall become subject to the provisions of section 38 of the FDI Act that restrict compensation paid to senior executive officers of the institution (section 38(f)(4)).

(4) *Additional provisions applicable to critically undercapitalized banks.* In addition to the provisions of section 38 of the FDI Act described in paragraphs (a) (2) and (3) of this section, immediately upon receiving notice or being deemed to have notice, as provided in § 208.32 of this subpart, that the bank is critically undercapitalized, the bank shall become subject to the provisions of section 38 of the FDI Act:

(i) Restricting the activities of the bank (section 38(h)(1)); and

(ii) Restricting payments on subordinated debt of the bank (section 38(h)(2)).

(b) *Discretionary supervisory actions.* In taking any action under section 38 that is within the Board's discretion to take in connection with: A state member bank that is deemed to be undercapitalized, significantly undercapitalized, or critically undercapitalized, or has been reclassified as undercapitalized, or significantly undercapitalized; an officer or director of such bank; or a company that controls such bank, the Board shall follow the procedures for issuing directives under §§ 263.202 and 263.204 of this chapter, unless otherwise provided in section 38 or this subpart.

Subparts C and D—[Reserved]

Subpart E—Interpretations

4. Subparts C and D are added to part 208 and reserved, the undesignated centerhead preceding section 208.116 is removed, §§ 208.116, 208.117, 208.122, and 208.124 through 208.128 are designated as subpart E of part 208, and the subpart E heading is added to read as set forth above.

PART 263—RULES OF PRACTICE FOR HEARINGS

1. The authority citation for 12 CFR Part 263 is revised to read as follows:

Authority: 5 U.S.C. 504; 12 U.S.C. 248, 324, 504, 505, 1817(j), 1818, 1828(c), 1831o, 1847(b), 1847(d), 1884(b), 1972(2) (F), 3105, 3107, 3108, 3907, 3909; 15 U.S.C. 21, 78o-4, 78o-5, and 78u-2.

2. Section 263.50(b) is amended by removing the word "and" at the end of paragraph (b)(9), removing the period at the end of paragraph (b)(10) and adding in its place a semicolon, and by adding paragraphs (b)(11) through (b)(14) to read as follows:

§ 263.50 Purpose and scope.

* * * * *

(b) * * *

(11) Issuance of a prompt corrective action directive to a member bank under section 38 of the FDI Act (12 U.S.C. 1831o);

(12) Reclassification of a member bank on grounds of unsafe or unsound condition under section 38(g)(1) of the FDI Act (12 U.S.C. 1831o(g)(1));

(13) Reclassification of a member bank on grounds of unsafe and unsound practice under section 38(g)(1) of the FDI Act (12 U.S.C. 1831o(g)(1)); and

(14) Issuance of an order requiring a member bank to dismiss a director or senior executive officer under section 38 (e)(5) and 38(f)(2) (F)(ii) of the FDI Act (12 U.S.C. 1831o(e)(5) and 1831o(f)(2)(F)(ii)).

3. A new subpart H is added to part 263 to read as follows:

Subpart H—Issuance and Review of Orders Pursuant to Prompt Corrective Action Provisions of the Federal Deposit Insurance Act

Sec.
§ 263.201 Scope.
§ 263.202 Directives to take prompt corrective action.
§ 263.203 Procedures for reclassifying a state member bank based on criteria other than capital.
§ 263.204 Order to dismiss a director or senior executive officer.
§ 263.205 Enforcement of directives.

Subpart H—Issuance and Review of Orders Pursuant to Prompt Corrective Action Provisions of the Federal Deposit Insurance Act

§ 263.201 Scope.

(a) The rules and procedures set forth in this subpart apply to state member banks, companies that control state member banks or are affiliated with such banks, and senior executive officers and directors of state member banks that are subject to the provisions of section 38 of the Federal Deposit Insurance Act (section 38) and subpart B of part 208 of this chapter.

§ 263.202 Directives to take prompt regulatory action.

(a) *Notice of intent to issue directive.*—(1) *In general.* The Board shall provide an undercapitalized, significantly undercapitalized, or critically undercapitalized state member bank or, where appropriate, any company that controls the bank, prior written notice of the Board's intention to issue a directive requiring such bank or company to take actions or to follow proscriptions described in section 38 that are within the Board's discretion to require or impose under section 38 of the FDI Act, including sections 38(e)(5), (f)(2), (f)(3), or (f)(5). The bank shall have such time to respond to a proposed directive as provided by the Board under paragraph (c) of this section.

(2) *Immediate issuance of final directive.* If the Board finds it necessary in order to carry out the purposes of section 38 of the FDI Act, the Board may, without providing the notice prescribed in paragraph (a)(1) of this section, issue a directive requiring a state member bank or any company that controls a state member bank immediately to take actions or to follow proscriptions described in section 38 that are within the Board's discretion to require or impose under section 38 of the FDI Act, including section 38(e)(5), (f)(2), (f)(3), or (f)(5). A bank or company that is subject to such an immediately effective directive may submit a written

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appeal of the directive to the Board. Such an appeal must be received by the Board within 14 calendar days of the issuance of the directive, unless the Board permits a longer period. The Board shall consider any such appeal, if filed in a timely matter, within 60 days of receiving the appeal. During such period of review, the directive shall remain in effect unless the Board, in its sole discretion, stays the effectiveness of the directive.

(b) *Contents of notice.* A notice of intention to issue a directive shall include:

(1) A statement of the bank's capital measures and capital levels;

(2) A description of the restrictions, prohibitions, or affirmative actions that the Board proposes to impose or require;

(3) The proposed date when such restrictions or prohibitions would be effective or the proposed date for completion of such affirmative actions; and

(4) The date by which the bank or company subject to the directive may file with the Board a written response to the notice.

(c) *Response to notice*—(1) *Time for response.* A bank or company may file a written response to a notice of intent to issue a directive within the time period set by the Board. The date shall be at least 14 calendar days from the date of the notice unless the Board determines that a shorter period is appropriate in light of the financial condition of the bank or other relevant circumstances.

(2) *Content of response.* The response should include:

(i) An explanation why the action proposed by the Board is not an appropriate exercise of discretion under section 38;

(ii) Any recommended modification of the proposed directive; and

(iii) Any other relevant information, mitigating circumstances, documentation, or other evidence in support of the position of the bank or company regarding the proposed directive.

(d) *Board consideration of response.* After considering the response, the Board may:

(1) Issue the directive as proposed or in modified form;

(2) Determine not to issue the directive and so notify the bank or company; or

(3) Seek additional information or clarification of the response from the bank or company, or any other relevant source.

(e) *Failure to file response.* Failure by a bank or company to file with the Board, within the specified time period, a written response to a proposed directive shall constitute a waiver of the opportunity to respond and shall constitute consent to the issuance of the directive.

(f) *Request for modification or rescission of directive.* Any bank or company that is subject to a directive under this subpart may, upon a change in circumstances, request in writing that the Board reconsider the terms of the directive, and may propose that the directive be rescinded or modified. Unless otherwise ordered by the Board, the directive shall continue in place while such request is pending before the Board.

§ 263.203 Procedures for reclassifying a state member bank based on criteria other than capital.

(a) *Reclassification based on unsafe or unsound condition or practice*—(1) *Issuance of notice of proposed reclassification*—(i) *Grounds for reclassification.* (A) Pursuant to § 208.33(c) of Regulation H (12 CFR 208.33(c)), the Board may reclassify a well capitalized bank as adequately capitalized or subject an adequately capitalized or undercapitalized institution to the supervisory actions applicable to the next lower capital category if:

(*1*) The Board determines that the bank is in unsafe or unsound condition; or

(*2*) The Board deems the bank to be engaged in an unsafe or unsound practice and not to have corrected the deficiency.

(B) Any action pursuant to this paragraph (a)(1)(i) shall hereinafter be referred to as "reclassification."

(ii) *Prior notice to institution.* Prior to taking action pursuant to § 208.33(c) of this chapter, the Board shall issue and serve on the bank a written notice of the Board's intention to reclassify the bank.

(2) *Contents of notice.* A notice of intention to reclassify a bank based on unsafe or unsound condition shall include:

(i) A statement of the bank's capital measures and capital levels and the category to which the bank would be reclassified;

(ii) The reasons for reclassification of the bank;

(iii) The date by which the bank subject to the notice of reclassification may file with the Board a written appeal of the proposed reclassification and a request for a hearing, which shall be at least 14 calendar days from the date of service of the notice unless the Board determines that a shorter period is appropriate in light of the financial condition of the bank or other relevant circumstances.

(3) *Response to notice of proposed reclassification.* A bank may file a written response to a notice of proposed reclassification within the time period set by the Board. The response should include:

(i) An explanation of why the bank is not in unsafe or unsound condition or otherwise should not be reclassified;

(ii) Any other relevant information, mitigating circumstances, documentation, or other evidence in support of the position of the bank or company regarding the reclassification.

(4) *Failure to file response.* Failure by a bank to file, within the specified time period, a written response with the Board to a notice of proposed reclassification shall constitute a waiver of the opportunity to respond and shall constitute consent to the reclassification.

(5) *Request for hearing and presentation of oral testimony or witnesses.* The response may include a request for an informal hearing before the Board or its designee under this section. If the bank desires to present oral testimony or witnesses at the hearing, the bank shall include a request to do so with the request for an informal hearing. A request to present oral testimony or witnesses shall specify the names of the witnesses and the general nature of their expected testimony. Failure to request a hearing shall constitute a waiver of any right to a hearing, and failure to request the opportunity to present oral testimony or witnesses shall constitute a waiver of any right to present oral testimony or witnesses.

(6) *Order for informal hearing.* Upon receipt of a timely written request that includes a request for a hearing, the Board shall issue an order directing an informal hearing to commence no later than 30 days after receipt of the request, unless the bank requests a later date. The hearing shall be held in Washington, DC or at such other place as may be designated by the Board, before a presiding officer(s) designated by the Board to conduct the hearing.

(7) *Hearing procedures.* (i) The bank shall have the right to introduce relevant written materials and to present oral argument at the hearing. The bank may introduce oral testimony and present witnesses only if expressly authorized by the Board or the presiding officer(s). Neither the provisions of the Administrative Procedure Act (5 U.S.C. 554–557) governing adjudications required by statute to be determined on the record nor the Uniform Rules of Practice and Procedure in subpart A of this part apply to an informal hearing

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under this section unless the Board orders that such procedures shall apply.

(ii) The informal hearing shall be recorded, and a transcript shall be furnished to the bank upon request and payment of the cost thereof. Witnesses need not be sworn, unless specifically requested by a party or the presiding officer(s). The presiding officer(s) may ask questions of any witness.

(iii) The presiding officer(s) may order that the hearing be continued for a reasonable period (normally five business days) following completion of oral testimony or argument to allow additional written submissions to the hearing record.

(8) *Recommendation of presiding officers.* Within 20 calendar days following the date the hearing and the record on the proceeding are closed, the presiding officer(s) shall make a recommendation to the Board on the reclassification.

(9) *Time for decision.* Not later than 60 calendar days after the date the record is closed or the date of the response in a case where no hearing was requested, the Board will decide whether to reclassify the bank and notify the bank of the Board's decision.

(b) *Request for rescission of reclassification.* Any bank that has been reclassified under this section, may, upon a change in circumstances, request in writing that the Board reconsider the reclassification, and may propose that the reclassification be rescinded and that any directives issued in connection with the reclassification be modified, rescinded, or removed. Unless otherwise ordered by the Board, the bank shall remain subject to the reclassification and to any directives issued in connection with that reclassification while such request is pending before the Board.

§ 263.204 Order to dismiss a director or senior executive officer.

(a) *Service of notice.* When the Board issues and serves a directive on a state member bank pursuant to § 263.202 requiring the bank to dismiss from office any director or senior executive officer under section 38(f) (2) (F) (ii) of the FDI Act, the Board shall also serve a copy of the directive, or the relevant portions of the directive where appropriate, upon the person to be dismissed.

(b) *Response to directive*—(1) *Request for reinstatement.* A director or senior executive officer who has been served with a directive under paragraph (a) of this section (Respondent) may file a written request for reinstatement. The request for reinstatement shall be filed within 10 calendar days of the receipt of the directive by the Respondent, unless further time is allowed by the Board at the request of the Respondent.

(2) *Contents of request; informal hearing.* The request for reinstatement shall include reasons why the Respondent should be reinstated, and may include a request for an informal hearing before the Board or its designee under this section. If the Respondent desires to present oral testimony or witnesses at the hearing, the Respondent shall include a request to do so with the request for an informal hearing. The request to present oral testimony or witnesses shall specify the names of the witnesses and the general nature of their expected testimony. Failure to request a hearing shall constitute a waiver of any right to a hearing and failure to request the opportunity to present oral testimony or witnesses shall constitute a waiver of any right or opportunity to present oral testimony or witnesses.

(3) *Effective date.* Unless otherwise ordered by the Board, the dismissal shall remain in effect while a request for reinstatement is pending.

(c) *Order for informal hearing.* Upon receipt of a timely written request from a Respondent for an informal hearing on the portion of a directive requiring a bank to dismiss from office any director or senior executive officer, the Board shall issue an order directing an informal hearing to commence no later than 30 days after receipt of the request, unless the Respondent requests a later date. The hearing shall be held in Washington, D.C., or at such other place as may be designated by the Board, before a presiding officer(s) designated by the Board to conduct the hearing.

(d) *Hearing procedures.* (1) A Respondent may appear at the hearing personally or through counsel. A Respondent shall have the right to introduce relevant written materials and to present oral argument. A Respondent may introduce oral testimony and present witnesses only if expressly authorized by the Board or the presiding officer(s). Neither the provisions of the Administrative Procedure Act governing adjudications required by statute to be determined on the record nor the Uniform Rules of Practice and Procedure in subpart A of this part apply to an informal hearing under this section unless the Board orders that such procedures shall apply.

(2) The informal hearing shall be recorded, and a transcript shall be furnished to the Respondent upon request and payment of the cost thereof. Witnesses need not be sworn, unless specifically requested by a party or the presiding officer(s). The presiding officer(s) may ask questions of any witness.

(3) The presiding officer(s) may order that the hearing be continued for a reasonable period (normally five business days) following completion of oral testimony or argument to allow additional written submissions to the hearing record.

(e) *Standard for review.* A Respondent shall bear the burden of demonstrating that his or her continued employment by or service with the bank would materially strengthen the bank's ability:

(1) To become adequately capitalized, to the extent that the directive was issued as a result of the bank's capital level or failure to submit or implement a capital restoration plan; and

(2) To correct the unsafe or unsound condition or unsafe or unsound practice, to the extent that the directive was issued as a result of classification of the bank based on supervisory criteria other than capital, pursuant to section 38(g) of the FDI Act.

(f) *Recommendation of presiding officers.* Within 20 calendar days following the date the hearing and the record on the proceeding are closed, the presiding officer(s) shall make a recommendation to the Board concerning the Respondent's request for reinstatement with the bank.

(g) *Time for decision.* Not later than 60 calendar days after the date the record is closed or the date of the response in a case where no hearing was requested, the Board shall grant or deny the request for reinstatement and notify the Respondent of the Board's decision. If the Board denies the request for reinstatement, the Board shall set forth in the notification the reasons for the Board's action.

§ 263.205 Enforcement of directives.

(a) *Judicial remedies.* Whenever a state member bank or company that controls a state member bank fails to comply with a directive issued under section 38, the Board may seek enforcement of the directive in the appropriate United States district court pursuant to section 8(i) (1) of the FDI Act.

(b) *Administrative remedies*—(1) *Failure to comply with directive.* Pursuant to section 8(i) (2) (A) of the FDI Act, the Board may assess a civil money penalty against any state member bank or company that controls a state member bank that violates or otherwise fails to comply with any final directive issued under section 38 and against any institution-affiliated party who

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participates in such violation or noncompliance.

(2) *Failure to implement capital restoration plan.* The failure of a bank to implement a capital restoration plan required under section 38, subpart B of Regulation H (12 CFR part 208, subpart B), or this subpart, or the failure of a company having control of a bank to fulfill a guarantee of a capital restoration plan made pursuant to section 38 (e) (2) of the FDI Act shall subject the bank or company to the assessment of civil money penalties pursuant to section 8(i) (2) (A) of the FDI Act.

(c) *Other enforcement action.* In addition to the actions described in paragraphs (a) and (b) of this section, the Board may seek enforcement of the provisions of section 38 or subpart B of Regulation H (12 CFR part 208, subpart B) through any other judicial or administrative proceeding authorized by law.

By order of the Board of Governors of the Federal Reserve System.

Dated: September 18, 1992.

William W. Wiles,

Secretary of the Board.

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