



# Offices of Inspector General

**Federal Deposit Insurance Corporation  
Department of the Treasury  
Board of Governors of the Federal Reserve System**

## **Evaluation of Prompt Regulatory Action Implementation**

**Report Numbers**

**EVAL-11-006  
OIG-CA-11-008  
FRB OIG 2011-05**

**September 2011**





## Offices of Inspector General

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**DATE:** September 30, 2011

**MEMORANDUM TO:** Ben S. Bernanke, Chairman  
Board of Governors of the Federal Reserve System

Martin J. Gruenberg, Acting Chairman  
Federal Deposit Insurance Corporation

John G. Walsh, Acting Comptroller  
Office of the Comptroller of the Currency

<b>FROM:</b>	/s/ Jon T. Rymer Inspector General Federal Deposit Insurance Corporation	/s/ Eric M. Thorson Inspector General Department of the Treasury	/s/ Mark Bialek Inspector General Board of Governors of the Federal Reserve System
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**SUBJECT:** *Evaluation of Prompt Regulatory Action Implementation*  
(Report Numbers: EVAL-11-006, OIG-CA-11-008, FRB OIG 2011-05)

Attached for your information is a copy of an evaluation report that the Offices of Inspector General (OIG) recently completed concerning the implementation of prompt regulatory action (PRA). The objectives of our evaluation were to (1) determine the purpose of and circumstances that led to the enactment of the PRA provisions and lessons learned from the banking and thrift crisis in the 1980s and early 1990s; (2) evaluate to what extent PRA provisions were a factor in bank failures and problem institutions during the current crisis; (3) assess whether PRA provisions prompted federal banking regulators to act more quickly and more forcefully to limit losses to the DIF in the current crisis in light of lessons learned from the 1980s and early 1990s; and (4) determine whether there are other non-capital measures that provide a leading indication of risks to the Deposit Insurance Fund that should be considered as part of PRA.

We made one recommendation including three matters for consideration to the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (FRB) and the Office of the Comptroller of the Currency intended to strengthen the effectiveness of the PRA provisions. Each of the agency responses to our draft report and the identified planned actions address the intent of the recommendation.

If you have questions concerning the report or would like to schedule a meeting to further discuss our evaluation results, please contact E. Marshall Gentry, FDIC OIG, at (703) 562-6378; Marla A. Freedman, Department of Treasury OIG, at (202) 927-5400, or Anthony J. Castaldo, FRB OIG, at (202) 973-5024. Thank you for your assistance with this evaluation.

Attachment

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## Abbreviations

Call Report	Report of Condition and Income
CAMELS	<u>C</u> apital, <u>A</u> sset quality, <u>M</u> anagement, <u>E</u> arnings, <u>L</u> iquidity, and <u>S</u> ensitivity to market risk
DIF	Deposit Insurance Fund
DIR	Division of Insurance and Research
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
FDI Act	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FRB	Federal Reserve Board
GAO	Government Accountability Office
MLR	Material Loss Review
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
PCA	Prompt Corrective Action
PFR	Primary Federal Regulator
PRA	Prompt Regulatory Action
RTC	Resolution Trust Corporation
TARP	Troubled Asset Relief Program
Treasury	U.S. Department of the Treasury

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*Federal Deposit Insurance Corporation  
Department of the Treasury  
Federal Reserve Board*

September 30, 2011

Ben S. Bernanke, Chairman  
Board of Governors of the Federal Reserve System

Martin J. Gruenberg, Acting Chairman  
Federal Deposit Insurance Corporation

John G. Walsh, Acting Comptroller of the Currency  
Office of the Comptroller of the Currency

This report presents the results of our evaluation of section 38 (Prompt Corrective Action, or PCA) and section 39 (Standards for Safety and Soundness) of the Federal Deposit Insurance Act (FDI Act). Referred to in this report as the prompt regulatory action (PRA) provisions, sections 38 and 39 were established by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991.<sup>1</sup> FDICIA was enacted to make fundamental changes in federal oversight of insured depository institutions in response to the financial crisis of the 1980s and early 1990s. The PRA provisions mandated that regulators establish a two-part regulatory framework for improving safeguards for the Deposit Insurance Fund (DIF).<sup>2</sup> Section 38 focuses on capital levels and section 39 focuses on non-capital measures of an institution's safety and soundness.

Section 38(k) also requires that our offices conduct Material Loss Reviews (MLR) of failed institutions that cause material losses to the DIF. As part of our review of the supervision of the failed institution, we examine the implementation of section 38. In addition to MLRs, prior studies by the Government Accountability Office (GAO) and our offices have assessed the implementation of

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<sup>1</sup> Pub. L. No. 102-242.

<sup>2</sup> From 1989 through March 2006, there were two deposit insurance funds. The Federal Deposit Insurance Reform Act of 2005 combined the two insurance funds into a single Deposit Insurance Fund. For the purposes of this report we refer to the insurance funds as the DIF.

PRA at various points, but those assessments were mostly done during periods when the financial condition of insured depository institutions was strong and, accordingly, the federal banking regulators' use of PRA was somewhat limited.<sup>3</sup> We initiated this review to further evaluate the role and federal banking regulators' use of the PRA provisions over the last several years in light of the significant increase in the number of troubled financial institutions and failures since mid-2007 (the current crisis), a period when those provisions came into play more frequently.

## **EVALUATION OBJECTIVES AND APPROACH**

The objectives of our evaluation were to:

1. Determine the purpose of and circumstances that led to the enactment of the PRA provisions and lessons learned from the banking and thrift crisis in the 1980s and early 1990s.
2. Evaluate to what extent PRA provisions were a factor in bank failures and problem institutions during the current crisis.
3. Assess whether PRA provisions prompted federal banking regulators to act more quickly and more forcefully to limit losses to the DIF in the current crisis in light of lessons learned from the 1980s and early 1990s.
4. Determine whether there are other non-capital measures that provide a leading indication of risks to the DIF that should be considered as part of PRA.

To address our objectives, we reviewed laws and regulations, legislative history, lessons learned from the financial crisis of the 1980s and early 1990s, and prior reports and studies on PRA, including MLR reports. We also selected and reviewed the supervisory history for two statistical samples of insured depository institutions to determine whether PRA-related supervisory actions were taken as required and the underlying cause necessitating such actions.

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<sup>3</sup> The federal banking regulators discussed in this report are the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). OCC and OTS are bureaus of the Department of the Treasury (Treasury). On July 21, 2011, in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the functions of OTS were transferred to OCC, FDIC, and FRB.

The first sample—111 institutions—was selected from the universe of institutions that had been undercapitalized for one or more quarters during the period January 2006 to March 2010. In total, there were 489 institutions in this universe. The second sample—118 institutions—was selected from the universe of institutions that had been designated as problem banks for one or more quarters during the period January 2006 to March 2010 but were never undercapitalized during this period. In total, there were 679 institutions in this universe. We also reviewed 120 MLRs for banks that failed during this period.

Appendix 1 includes additional detail on our objectives, scope, and methodology. We performed our evaluation between May 2010 and May 2011 in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation*.

We also coordinated our review with GAO. GAO was required under the Dodd-Frank Act to study the federal banking regulators' use of PCA.<sup>4</sup>

Our report is divided into three sections. Section I addresses the first objective and provides the overall context for assessing implementation of PRA provisions. Section II addresses the second and third objectives by describing the extent to which PRA provisions have been a factor in supervisory activity during the current crisis and our assessment of the impact of PRA provisions in limiting losses to the DIF. Section III addresses the fourth objective by introducing non-capital factors that provide a leading indication of bank problems and recommends matters for the federal banking regulators' consideration to strengthen the effectiveness of the PRA provisions. Appendix 4 provides a glossary of certain terms used in this report. Those terms, where first used, are underlined.

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<sup>4</sup> *Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness*, GAO-11-612, June 2011.

## Results in Brief

**History of Provisions and Results of Prior Reviews.** Congress enacted sections 38 and 39 as part of a broader effort to address problems experienced during the banking crisis of the 1980s and early 1990s. Those problems included, among other things, a concern that the exercise of regulatory discretion did not adequately protect the safety and soundness of the banking system or minimize losses to the DIF. The FDIC's *History of the Eighties – Lessons for the Future*<sup>5</sup> outlined a number of lessons about the performance of bank regulators during that period. Treasury and GAO were also required to conduct studies of the nation's deposit insurance system. In our view, the following lessons from those documents are relevant to understanding issues and expectations surrounding the development and implementation of PRA provisions:

- Early identification of problems is critical and requires continuous and sometimes burdensome monitoring of the institutions' activities.
- Regulators had difficulty restricting risky behavior while institutions were profitable.
- Regulators must have adequate powers and a willingness to use supervisory authority.
- The regulatory process had better outcomes when regulators took the most forceful action available.
- Capital was a lagging indicator, yet the timing of enforcement actions tended to focus on capital inadequacy rather than underlying problems.

The addition of sections 38 and 39 to the FDI Act was intended to improve the regulators' ability to identify and promptly address deficiencies at an institution to better safeguard the DIF. Section 38 principally establishes capital-based safeguards, and section 39 directs regulatory attention to noncapital areas of an institution's operations and activities.

**Use and Impact of PRA During the Crisis.** In terms of PRA-related activity during the current crisis, we found that approximately 6 percent of all insured institutions (489 of 8,494) fell below the minimum capital requirements established by section 38 (i.e., were undercapitalized) between January 2006 and March 2010.

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<sup>5</sup> Volume 1 – An Examination of the Banking Crisis of the 1980s and Early 1990s.

We refer to these institutions as “PCA banks” in this report. PCA banks accounted for approximately 39 percent of the problem banks and 90 percent of all failures. With the exception of the OCC, regulators rarely used their section 39 authority, which was designed to address deficiencies related to an institution’s operations and activities other than inadequate capital, opting instead to address deficiencies using other regulatory tools and/or authorities.

With respect to whether PRA provisions prompted regulators to act more quickly and more forcefully to limit losses to the DIF, our findings are generally consistent with prior reviews: PRA provisions were appropriately implemented and helped strengthen oversight to a degree. More specifically, we found:

- **Regulators implemented PCA appropriately.** Based on our review of a sample of PCA banks, including banks that failed, we found that regulators generally implemented section 38 provisions as required. The appropriate implementation of section 38 helped prevent seriously troubled institutions from engaging in high-risk strategies to restore capital and limited regulatory discretion and/or forbearance for undercapitalized institutions. These two factors had been a common concern in the pre-FDICIA era. However, the fact that 60 percent of PCA banks failed (291 of 489) supports the conclusion of prior studies that by the time seriously troubled banks become subject to mandatory provisions under section 38, there are few options available to resolve the problems of those institutions.
- **Inherent limitations associated with PCA’s capital-based framework and the sudden and severe economic decline impacted PCA’s effectiveness.** As prior reviews have reported, section 38’s capital-based regulatory approach has inherent limitations. Capital is a lagging indicator and does not typically begin to decline until an institution has experienced substantial deterioration in other areas, such as asset quality and the quality of bank management, as reflected in examiners’ ratings. Further, reported capital levels do not always accurately reflect an institution’s financial condition, either due to rapidly declining asset values or an institution’s delay in recognizing asset write-downs. The suddenness and severity of the economic decline during this crisis also impacted PCA’s

effectiveness in terms of resolving the problems of troubled institutions.

- **Regulators identified deficiencies prior to declines in PCA capital categories.** Regulators generally identified deficiencies, including capital deficiencies, before the institutions became PCA banks. For example, during the period of our review, a large percentage of PCA banks were first designated as problem banks – defined as those banks with CAMELS ratings of “4” or “5” – and 61 percent of the problem banks had never been undercapitalized.

We found that examiner concerns with asset quality and management were the leading indicators of whether a bank would become a problem bank, become undercapitalized, or fail, which is similar to the experience of the financial crisis of the 1980s and 1990s.

- **Regulators used other enforcement actions to address safety and soundness concerns before undercapitalization, but after financial decline occurred.** Most of the PCA banks (86 percent) and problem banks (96 percent) in our samples had formal enforcement actions in place. In most cases, regulators imposed formal enforcement actions before troubled banks became undercapitalized. However, MLR reports often concluded that, although regulators identified the risks, in hindsight, earlier supervisory concern and intervention would have been prudent. The results of our MLRs indicate that, similar to the experience of the 1980s and early 1990s, the ability of regulators to curb excessive risk when the risky behavior was profitable (i.e., before financial condition deteriorated) remained a challenge.
- **Regulators made limited use of section 39 to address asset quality and management deficiencies identified.** Accordingly, section 39 had little impact on problem or failed banks during this crisis. Section 39 was intended to provide regulators with a tool to effect corrective action in seemingly healthy banks with operational or risk management weaknesses. However, the regulators generally used other regulatory tools that, in their view, provided greater flexibility and were equally effective. OCC did use section 39 to require 21 institutions to submit compliance plans to address safety and soundness issues during our period of review.

- **Critically undercapitalized institutions were closed promptly, but overall losses were significant.** Although PCA was intended to result in reduced loss rates, preliminary cost data suggests that losses were significant during the current crisis, and losses as a percentage of assets are higher in comparison to loss rates experienced in the 1980s and early 1990s. FDIC officials noted that making loss rate comparisons at this point may be premature because current loss figures are best estimates that may not reflect actual loss experience over the next 5-10 years. Bank losses significantly depleted the DIF, which remained in a negative position until the quarter ending June 30, 2011.

**Leading Indicators and Matters for Consideration.** Going forward, the question is how to effectively address safety and soundness concerns prior to financial deterioration to avoid, or at least lessen, significant failures and losses emanating from a future crisis. The Congress, the FDIC, and the other banking agencies have responded to the financial crisis by planning and undertaking numerous initiatives to strengthen regulatory oversight. These efforts include the landmark Dodd-Frank Act and internal initiatives by the banking agencies. Further, in June 2011, GAO issued a study of PCA with recommended actions for the banking agencies. GAO found that non-capital measures – earnings, liquidity, asset quality, and asset concentration risk – were statistically valid and significant predictors of bank failure during the current crisis period.

We also identified non-capital factors that are leading indicators of potential troubles that may strengthen the PRA framework if used as triggers for mandatory regulatory intervention. These factors are not new, and examiners at the regulatory agencies consider them during safety and soundness examinations. These factors include high-risk business strategies, such as aggressive growth, asset concentrations, and dependence on volatile funding sources; risk management weaknesses, such as poor underwriting and credit administration practices; and asset quality or earnings deterioration.

The PRA provisions were intended to supplement existing regulatory enforcement tools. Accordingly, we evaluated regulators' use of these supplemental enforcement tools and other supervisory actions to help assess PRA's effectiveness and

identify areas for improvement. In that regard, we are recommending that the banking agencies consider the following options to strengthen, or indirectly support, the PRA provisions: (1) develop specific criteria and corresponding enforcement actions for non-capital factors, (2) increase the minimum PCA capital levels, and (3) continue to refine the deposit insurance system to assess greater premiums commensurate with risk-taking. We recognize that in evaluating these matters there may be differences with respect to large and small institutions.

## SECTION I

# Prompt Regulatory Action: History, Provisions, and Prior Reviews

## **PRA: History, Provisions, and Prior Reviews**

The enactment of the PRA provisions was part of a broader response to the banking and thrift crisis of the 1980s and early 1990s. According to the FDIC's *Managing the Crisis: The FDIC and RTC Experience 1980-1994*, August 1998,<sup>6</sup> 1,617 insured banks and 1,295 savings and loan institutions were closed or received financial assistance from 1980 through 1994. Those failures resulted in resolution costs of \$197.6 billion (\$317.8 billion in 2011 dollars). The number of failures and losses associated with those failures was unprecedented and resulted in federal banking regulators being criticized for not taking prompt and forceful action to minimize or prevent losses to the DIF.

At that time, the regulatory system came under intense scrutiny, and fundamental questions were raised about the effectiveness of the bank regulatory and deposit insurance systems. These questions became a catalyst for far-reaching legislative and regulatory changes, among which was enactment of the PRA provisions in FDICIA.<sup>7</sup> Prior reviews of PRA generally concluded that the provisions strengthened oversight to a degree but may not have prompted regulators to take early enforcement action to prevent or limit losses to the DIF.

### **History Leading to the PRA Provisions**

Industry analysts have recognized many factors that contributed to the high level of thrift and bank failures in the 1980s and early 1990s. One factor often cited was excessive forbearance by regulators. Congress enacted FDICIA, in part, because of concerns that the exercise of regulatory discretion during the

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<sup>6</sup> The FDIC conducted two studies of the banking and thrift crisis. The *History of the Eighties – Lessons for the Future*, published in December 1997, provided (1) a detailed analysis of the causes that led to the extraordinary number of bank failures in the 1980s and early 1990s; (2) an evaluation of the legislative, regulatory, and supervisory responses to those failures; and (3) an assessment of the future implications those experiences would have on deposit insurance and bank supervision. *Managing the Crisis: The FDIC and RTC Experience 1980 – 1994*, published in August 1998, examined the manner in which the FDIC and the Resolution Trust Corporation (RTC) handled the bank and thrift failures and documented the evolution of the methods used to resolve failed institutions, pay depositors their money, and dispose of the large volume of assets that remained.

<sup>7</sup> FDICIA contained several provisions that were intended to collectively improve the supervision of federally insured depository institutions. For example, FDICIA included a number of corporate governance and accounting reforms and supervision reforms. The PRA provisions were among the supervision reforms.

1980s did not adequately protect the safety and soundness of the banking system or minimize DIF losses.

Further, during the 1980s and early 1990s, the deposit insurance guarantee was seen as an incentive for financial institutions, especially troubled banks, to undertake riskier investments with depositors' insured funds. During that period, an undercapitalized institution had a strong incentive to take risks because the institution would benefit if the strategy proved successful but pass any losses to the insurance funds. Therefore, adequate capital was seen as critical in any reform to ensure bank directors and management had sufficient incentives to fully consider the cost of risk-taking.

### Lessons from the Eighties

The FDIC's *History of the Eighties – Lessons for the Future* outlined a number of lessons about the performance of bank regulators during that period. In our view, the following lessons are relevant to understanding issues and expectations surrounding the development and implementation of PRA provisions:

**Problems in the operations of depository institutions must be identified at an early stage if serious deterioration in the institutions' condition is to be prevented, and early identification requires continuous and sometimes burdensome monitoring of the institutions' activities.** According to the study, emerging problems were not always identified on a timely basis during the first half of the 1980s crisis, in part, because of an increased reliance on off-site monitoring and a concurrent reduction in the number of bank examiners and frequency of on-site examinations.

**The ability of regulators to curb excessive risk-taking on the part of currently healthy banks was limited by the problem of identifying risky activities before they produced serious losses and by competing public policy objectives.** The FDIC's study noted that bank regulators were reasonably successful in curbing risk-taking on the part of officially designated problem banks whose condition had already deteriorated. However, in dealing with ostensibly healthy banks, regulators had difficulty restricting risky behavior before the problems arose, while the banks were still solvent and the risky behavior was widely practiced and profitable. Examiners stated that as long as a bank was profitable, it was difficult to persuade bank management or

regulatory supervisors that problems could lie ahead. Once the risky behavior resulted in losses, however, regulators were more effective. Unfortunately, by that time, the damage had been done, and efforts to resolve the problems of the institution had limited success.

**Bank regulation can limit the scope and cost of bank failures but is unlikely to prevent failures that have systemic causes.** The rise of bank failures in the 1980s had many causes beyond the regulators' power to influence or offset, including broad economic and financial market changes. Earlier implementation of uniform capital standards or other improvements in regulation might have reduced the number of failures in the 1980s but could not have prevented a great many of them.

#### Reports on Deposit Insurance Reform and Use of Enforcement Actions

In response to the banking and thrift crisis, Congress mandated<sup>8</sup> that Treasury and GAO conduct studies of the nation's deposit insurance system and develop proposals for reforming the system. Congress also requested that GAO review the effectiveness of regulators' enforcement activities to ensure that banks were operating in a safe and sound manner.

Treasury's February 1991 report to Congress, *Modernizing the Financial System, Recommendations for Safer, More Competitive Banks* (Treasury report), recommended reforms centered on improving supervision by strengthening the role of capital. Specifically, Treasury recommended establishing "zones" for banks based on their particular levels of capital. Banks that did not maintain high levels of capital would be subject to progressive and well-defined sanctions. The Treasury report emphasized that "prompt corrective action" would address the criticism that regulators waited too long to act. The Treasury report based the ability of regulators to take effective early corrective action on three factors:

**Regulators' ability to identify undercapitalized banks before they impose a loss on the DIF.** The Treasury report concluded that both reported financial data and examination ratings sometimes

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<sup>8</sup> Required by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 Pub. L. No. 101-73.

give a misleadingly optimistic picture of a bank's condition until relatively shortly before it fails. Therefore, the degree to which early corrective action can make a difference to deposit insurance costs may be limited in cases where problems go undetected in terms of reported capital levels, supervisory ratings, or both.

**Regulators' access to adequate powers to force correction or prevent further deterioration.** Regulators have a number of options available to correct problems at banks once they have been identified. The Treasury report noted that there was disagreement concerning the adequacy of regulatory power and did not make a recommendation for more power.

**Regulators' willingness to use supervisory authority.** The Treasury report noted that it was frequently alleged that regulators have the tools to control bank risk but lack the incentive to use those tools. The report concluded that it was difficult, if not impossible, to determine whether regulators inappropriately delayed using their authority.

GAO issued reports required by legislation<sup>9</sup> and in response to Congress' request.<sup>10</sup> GAO found that:

**The regulatory process had better outcomes when regulators took the most forceful action available to them.** GAO's study found that regulators did not always use the most forceful enforcement actions and shared a common philosophy of trying to work cooperatively with banks to resolve safety and soundness problems, known as moral suasion. The combination of wide discretion and a cooperative philosophy often did not resolve the problems that regulators had identified. Additionally, in a number of cases, GAO found that the underlying causes for problems were known but remained uncorrected and/or the bank had a history of noncompliance with existing enforcement actions or of repeatedly violating banking regulations.

**Bank capital was typically a lagging indicator of bank problems; nevertheless, regulatory enforcement actions tended to focus on capital inadequacy, rather than on underlying problems, as a key**

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<sup>9</sup> *Deposit Insurance: A Strategy for Reform* (GAO/GGD-91-26), issued in March 1991.

<sup>10</sup> *Bank Supervision: Prompt and Forceful Regulatory Actions Needed* (GAO/GGD-91-69). GAO studied regulators' actions to enforce safety and soundness practices by analyzing 72 banks from the universe of banks that as of January 1, 1988, were identified by regulators as having difficulty meeting minimum capital standards established by regulation.

**indicator of unsafe and unsound practices.** Further, capital difficulties were typically caused by earlier problems involving bank assets, earnings, and/or management. Such problems included (1) asset growth that was not accompanied by comparable increases in capital and (2) high exposures to risk created by heavy concentrations in specific types of assets, industries, or local economies. The most frequently cited reasons for asset problems involved banks' underwriting practices and lax or non-compliant lending practices. GAO traced earnings and asset problems to the quality of bank management and found that regulators often cited management problems such as a lack of management expertise, unwillingness or inability to address prior enforcement actions, and dominant bank or board officials. GAO found that examiners frequently identified and warned bank management of these problems and that many of these problems predated capital deficiencies by more than a year. GAO found that clear-cut regulatory measures of unsafe and unsound practices existed for capital but not for other aspects of bank operations such as asset or earnings quality.

GAO concluded that meaningful reform of the deposit insurance system would not succeed without an enforcement process that was more predictable, more credible, and less discretionary than the approach used at the time. GAO recommended that Congress establish a regulatory "tripwire" system that would require prompt and forceful action tied to specific unsafe banking practices. The intent of the tripwire system would be to focus regulatory attention on objective indicators of unsafe activities and conditions and create a set of expectations among banks and regulators concerning enforcement actions that would follow.

An important feature of GAO's tripwire system was that the earliest tripwires would enable regulators to take forceful action to stop risky behavior before the capital of a bank began to fall because when bank capital fell below the regulatory minimum, it was often too late to do much about the condition of the bank or the FDIC's losses. Specifically, GAO proposed that the first tripwire address unsafe activities that indicate management inadequacies that could lead to further financial problems – i.e., unsafe practices in seemingly healthy institutions. This tripwire was aimed at addressing the fact that regulators routinely identified problems or risks but often did not act decisively on the problems found because the consequences of those problems had not yet had an adverse financial effect.

The federal banking regulators expressed concerns about (1) a tripwire approach constraining decisionmaking; (2) the feasibility of establishing quantifiable measures for all components of bank operations that are examined, particularly for bank management; and (3) the discretion that regulators need to consider the specific facts and circumstances of each bank examined in determining the most appropriate enforcement action to take. GAO responded that the tripwire approach would reduce – not eliminate – discretion. GAO also reaffirmed its belief that the regulators could establish quantifiable measures for all bank components, including management.

### **FDICIA and Sections 38 and 39 of the FDI Act**

FDICIA was Congress' first systematic attempt to reform federal deposit insurance. With the passage of FDICIA, Congress sought to better align incentives of insured depository institutions' owners, managers, and regulators with the interests of the DIF. Specifically, the addition of sections 38 and 39 to the FDI Act was intended to improve the regulators' ability to identify and promptly address deficiencies at an institution to better safeguard the DIF and supplement existing supervisory authority.

#### Section 38 – Prompt Corrective Action

The stated purpose of section 38 is to resolve the problems of insured depository institutions at the least possible long-term loss to the DIF. Section 38 required bank regulators to act promptly to prevent troubled banks from becoming taxpayer liabilities and to resolve the problems of troubled institutions while the institutions had capital to absorb their own losses, protecting the deposit insurance system and the taxpayers.

Specifically, section 38 created a capital-based framework for bank and thrift oversight based on the placement of financial institutions into one of five capital categories. Banking regulators use three different capital measures to determine an institution's capital category: (1) a total risk-based capital ratio, (2) a Tier 1 risk-based capital ratio, and (3) a leverage capital ratio. Table 1 illustrates the capital level requirements for each capital category.

**Table 1: PCA Defined Capital Categories**

PCA Capital Category	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Leverage Capital Ratio
Well Capitalized	10% or more and	6% or more and	5% or more
Adequately Capitalized	8% or more and	4% or more and	4% or more
Undercapitalized	Less than 8% or	Less than 4% or	Less than 4%
Significantly Undercapitalized	Less than 6% or	Less than 3% or	Less than 3%
Critically Undercapitalized	An institution is critically undercapitalized if its tangible equity is 2% or less regardless of its other capital ratios.		

Source: FDIC – 12 C.F.R. § 325.103 (2006), Federal Reserve – 12 C.F.R. § 208.43 (2006), OCC – 12 C.F.R. § 6.4 (2006), OTS – 12 C.F.R. § 565.4 (2006).

Institutions face increasingly stringent restrictions at each capitalization level below adequately capitalized. For example, under section 38, an institution faces restrictions related to asset growth and dividends, is required to develop a capital restoration plan, and may ultimately be placed into receivership if capital levels become critically low.

### Section 39 – Standards for Safety and Soundness

Section 39 sought to limit deposit insurance losses by addressing factors other than inadequate capital. Specifically, section 39 required regulators to develop and implement safety and soundness standards in three areas:

1. **Operations and Management** – internal controls, information systems, internal audit, loan documentation, credit underwriting, and interest rate exposure.
2. **Asset Quality, Earnings, and Stock Valuation** – ratio of classified assets to capital, minimum earnings to absorb losses without impairing capital, and market value to book value of shares.
3. **Compensation** – compensation, fees, or benefits that are excessive or could lead to financial loss.

Initially, the standards for asset quality and earnings were to be quantitative and require federal banking regulators to take formal actions against institutions not meeting prescribed safety and

soundness standards. However, the Riegle Community Development and Regulatory Improvement Act of 1994,<sup>11</sup> amended section 39 and allowed the standards to be issued by regulation (as originally specified by FDICIA) or by guideline and eliminated the requirement to establish quantitative standards for asset quality, earnings, and stock valuations. The federal banking regulators chose to prescribe the standards through guidelines rather than regulation, essentially providing them with flexibility in how and when they would take action against institutions that failed to meet the standards. The amendments were enacted in response to concerns about the potential regulatory burden on banks and thrifts associated with section 39.

In 1995, the federal banking regulators issued the *Interagency Guidelines Establishing Standards for Safety and Soundness*,<sup>12</sup> which set out broad standards under section 39 on sound banking practices for internal controls; information systems; internal audit systems; loan documentation; credit underwriting; interest rate exposure; asset growth; and compensation, fees, and benefits.

### **Prior Reviews of PRA Effectiveness**

Prior to the current financial crisis, our offices and GAO had assessed the federal banking regulators' implementation of PRA provisions in four separate studies. In general, all the prior studies noted that the regulators effectively used section 38 provisions when an institution became undercapitalized and found there was little use of the section 39 provisions to correct problems before capital deterioration. However, some common themes emerged with respect to section 38, including:

- Capital-based safeguards are inherently limited because capital does not typically show a decline until an institution has experienced substantial deterioration in other components of its operations and finances. Consequently, by the time seriously troubled institutions become subject to section 38's mandatory restrictions and enforcement actions, there may be few options available to prevent or minimize losses to the DIF.
- Regulators responded to safety and soundness problems in advance of a bank's or thrift's decline in required capital levels.

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<sup>11</sup> Pub. L. No. 103-325.

<sup>12</sup> 60 Fed. Reg. 35674 (Jul. 10, 1995).

- The implementation of PCA depends on the accuracy of capital ratios reported in Reports of Condition and Income (Call Reports) and Thrift Financial Reports, which may not always be accurate.

Appendix 3 identifies each of the reports and summarizes key findings.

## SECTION II

# Prompt Regulatory Action: Use and Impact During the Current Crisis

## **PRA Provisions: Use and Impact During the Current Crisis**

The crisis that began in 2007 was the first major financial crisis since FDICIA was enacted to test the effectiveness of PRA provisions in improving regulators' ability to identify and promptly address deficiencies at an institution to better safeguard the DIF. In this section of the report, we discuss (1) the extent that PRA provisions were a factor in problem institutions between January 2006 and March 2010 and bank failures through December 2010 and (2) whether the PRA provisions prompted regulators to act more quickly and forcefully to limit losses relative to the pre-FDICIA era. In large measure, our findings are consistent with prior reviews – PRA provisions were appropriately implemented and helped strengthen oversight to a degree. More specifically, we found the following:

- Inherent limitations associated with PCA's capital-based framework and the sudden and severe economic decline impacted PCA's effectiveness in resolving the problems of institutions during this crisis.
- Regulators identified deficiencies prior to declines in PCA capital categories.
- Regulators took action to address safety and soundness concerns before undercapitalization but after financial decline occurred.
- Regulators made limited use of section 39 to address asset quality and management deficiencies.
- Critically undercapitalized institutions were closed promptly, but overall losses were significant.

### **Regulators Implemented PCA Appropriately**

Based on our review of a sample of PCA banks, including banks that failed, we found that regulators generally implemented section 38 provisions as required, meaning that regulators routinely monitored capital levels, imposed increasingly restrictive mandatory provisions as capital levels decreased, and acted quickly to close critically undercapitalized institutions. We identified 489 PCA banks for our review period (i.e., banks that

failed to meet or fell below minimum capital requirements defined in section 38 for at least one quarter between January 2006 and March 2010). Table 2 illustrates how these PCA banks relate to the universe of all insured institutions, well or adequately capitalized problem banks, and banks that ultimately failed.

**Table 2: Well or Adequately Capitalized Problem Banks, PCA Banks, and Other Insured Institutions, January 2006 to March 2010**

	Well or Adequately Capitalized Problem Banks <sup>a</sup>	PCA Banks <sup>a</sup>	Non-Problem and Non-PCA Banks	Total Insured Institutions
Number of Insured Institutions	679 (Sample 118)	489 (Sample 111)	7,326	8,494
As a Percentage of Total Insured Institutions	8%	6%	86%	100%
Failed Institutions Through December 2010	25	291	9 <sup>b</sup>	325 (Sample 120)
As a Percentage of Failed Institutions	8% <sup>c</sup>	90% <sup>c</sup>	3% <sup>c</sup>	100%
As a Percentage of Insured Institutions	4%	60%	Less than 1%	4%

Source: OIG analysis of FDIC data.

<sup>a</sup> We identified a total of 1,122 problem banks during our review period, which was comprised of 679 well or adequately capitalized banks and 443 PCA banks. An additional 46 PCA banks were not designated as problem banks.

<sup>b</sup> Eight of these banks were designated as problem banks for short periods of time between the quarterly problem bank lists, but failed before appearing on a quarterly problem bank list.

<sup>c</sup> Amounts do not total 100% due to rounding.

We found that regulators routinely used quarterly Call Reports and Thrift Financial Reports and onsite examination activity to monitor the condition of institutions, including capital levels. Accordingly, when an institution failed to meet minimum capital levels (i.e., PCA banks), the institution became subject to mandatory PCA provisions. The PCA provisions are intended to ensure swift regulatory response to prevent further erosion of an institution’s capital, and the regulatory response becomes more severe as an institution’s capital declines. The Senate report on FDICIA stated that “as an institution’s financial condition declines, regulators must take meaningful measures to restore the institution to health, culminating in appointing a conservator or receiver to the institution if it ultimately proves impossible to turn it around through less drastic measures.”<sup>13</sup> Table 3 outlines mandatory and discretionary PCA actions in more detail.

<sup>13</sup> Senate Rep. No. 102-167, p. 32 (Oct. 1, 1991).

**Table 3: Section 38 Mandatory and Discretionary Actions**

Capital Level	Mandatory Provisions	Discretionary Provisions
Well Capitalized	None	None
Adequately Capitalized	No new brokered deposits or rollovers except with FDIC waiver. <sup>a</sup>	
Undercapitalized	<ol style="list-style-type: none"> <li>1. Suspend dividends and management fees.</li> <li>2. Require capital restoration plan.<sup>b</sup></li> <li>3. Restrict asset growth.</li> <li>4. Require approval for acquisitions, branching, and new activities.</li> <li>5. Monitor institution conditions and compliance with section 38 requirements.</li> <li>6. Prohibit brokered deposits.</li> </ol>	<p>Regulators may take any action below:</p> <ol style="list-style-type: none"> <li>1. Order recapitalization.</li> <li>2. Restrict inter-affiliate transactions.</li> <li>3. Restrict deposit interest rates.</li> <li>4. Restrict asset growth.</li> <li>5. Restrict activities that pose excessive risk.</li> <li>6. Improve management by ordering new board of directors election and/or qualified senior executive officers.</li> <li>7. Prohibit deposits from correspondent banks.</li> <li>8. Require approval for capital distributions by bank holding companies.</li> <li>9. Require divestiture by the institution, by the parent company, or by any company having control of the institution.</li> <li>10. Take any other actions that would better carry out PCA.</li> </ol>
Significantly Undercapitalized	<ol style="list-style-type: none"> <li>1. Same as for Undercapitalized.</li> <li>2. Order recapitalization.<sup>c</sup></li> <li>3. Restrict inter-affiliate transactions.<sup>c</sup></li> <li>4. Restrict deposit interest rates.<sup>c</sup></li> <li>5. Restrict pay of officers.</li> <li>6. Improve management (dismiss directors and senior managers).</li> <li>7. Regulators shall take one or more of the discretionary actions noted above for undercapitalization.</li> </ol>	<ol style="list-style-type: none"> <li>1. Conservatorship or receivership if institution fails to submit or implement plan or recapitalize pursuant to order.</li> <li>2. Any action under critically undercapitalized provisions if such action is necessary to carry out prompt corrective action.</li> </ol>
Critically Undercapitalized	<ol style="list-style-type: none"> <li>1. Same as significantly undercapitalized.</li> <li>2. Appoint receiver/conservator within 90 days.<sup>c</sup></li> <li>3. Appoint receiver if still critically undercapitalized for 4 quarters.</li> <li>4. Suspend payments on subordinated debt.<sup>c</sup></li> <li>5. Restrict certain other activities unless written approval provided by the FDIC.</li> </ol>	
<p><sup>a</sup> The restrictions on brokered deposits for institutions that are less than well capitalized are found in section 29 of the FDI Act and codified at 12 U.S.C. §1831f.</p> <p><sup>b</sup> Regulators shall take additional actions if institutions fail to submit or implement capital restoration plans.</p> <p><sup>c</sup> Not required if the primary regulator determines action would not serve the purpose of prompt corrective action or if certain other conditions are met.</p>		

Source: Section 38 of the FDI Act and GAO Reports, 12 C.F.R. § 303.243.

The mandatory provisions become effective immediately by operation of law, meaning that no action is required on the part of regulators. Although not required to do so by regulation, we found that regulators routinely sent notification letters advising banks of the mandatory requirements and restrictions associated with their section 38 capital category.<sup>14</sup> Regulators must issue a PCA-related supervisory directive<sup>15</sup> when imposing discretionary provisions. Alternatively, regulators may use other enforcement authority, for example enforcement action authority under section 8 of the FDI Act, to address concerns related to capital instead of or in conjunction with a supervisory directive.<sup>16</sup>

In addition to mandatory restrictions defined in section 38, section 29 of the FDI Act imposes restrictions on an institution's funding sources based on capital levels defined in section 38.<sup>17</sup> Specifically, under section 29, institutions that are not well capitalized are prohibited from obtaining or rolling over brokered deposits; however, adequately capitalized institutions may request a waiver of the prohibition. Brokered deposits are a more volatile source of funding than other types of core deposits, and limiting the use of brokered deposits when an institution falls below minimum capital requirements helps to prevent the bank from using high-risk strategies to try to grow out of its problems.

Further, section 38(g) allows regulators to take action based on supervisory criteria other than capital. Specifically, regulators may reclassify a well capitalized, adequately capitalized, or undercapitalized institution to the next lower capital category and impose those mandatory actions if the bank is in an unsafe or unsound condition or engaged in an unsafe and unsound practice that remains uncorrected.<sup>18</sup> With the exception of the OCC, none of the regulators used section 38(g) to reclassify an institution to a lower capital category based on non-capital safety and soundness concerns. The OCC used section 38(g) on two occasions, in one instance using section 38(g) to dismiss bank

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<sup>14</sup> FDIC Memorandum, *Use of Notification and Reconfirmation Letters under Prompt Corrective Action*, September 30, 1996, and OCC's *An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution* (Jan. 2001).

<sup>15</sup> A supervisory directive is a final order to a bank that fails to maintain capital at or above minimum requirements. The directive is enforceable in the same manner and to the same extent as a final cease and desist order.

<sup>16</sup> 12 C.F.R. §325.101(d).

<sup>17</sup> 12 U.S.C. 1831f.

<sup>18</sup> 157 Fed. Reg. 44897 (Sept. 29, 1992).

management. The process for taking a section 38(g) action can be time-consuming because it requires notice and an opportunity for a hearing before the institution can be reclassified to the next lower capital category. According to the FDIC's *Formal and Informal Action Procedures Manual*, an order under section 8 of the FDI Act is often the fastest means of obtaining correction of an unsafe and unsound practice, particularly if an institution stipulates to the issuance of the order.

We found that the federal banking regulators issued 91 PCA directives between January 2006 and March 2010 as shown in Table 4.

**Table 4: PCA Directives, January 2006 to March 2010**

Regulator	Number
FRB	16
FDIC	35
OCC	6
OTS	34
Total	91

Source: FRB, FDIC, OCC, and OTS public Web sites.

Supervisory directives were issued to, among other things, follow up on supervisory concerns related to capital restoration plans, force an institution to recapitalize or merge, and dismiss bank officers. As discussed later in this report, regulators made limited use of section 38 supervisory directives because problems were identified before declines in capital, and, in most cases, supervisory action had already been taken or initiated.

The regulators resolved all of the institutions that became critically undercapitalized between January 2006 and March 2010 within the 90-day statutory time frame or within an allowable extension. Specifically, regulators closed 105 of 117 critically undercapitalized institutions within 90 days as required. The regulators closed the remaining 12 institutions within 91 to 129 days of the institution becoming critically undercapitalized. The 90-day period may be extended, provided the regulator and the FDIC concur and document why an extension would better serve the purposes of the provision, but after 270 days, a receiver or conservator must be appointed unless the regulator and the FDIC certify that the institution is viable and not expected to fail.

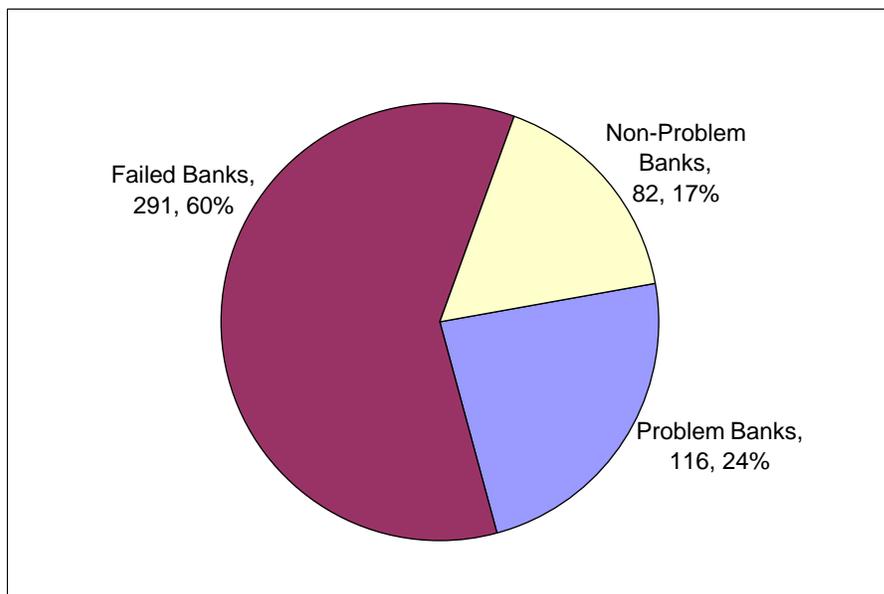
Regulators told us that the requirement to close critically undercapitalized institutions promptly was beneficial because it established a “bright line” that was easily understood by the state regulators and bank officials. In this regard, the closure of critically undercapitalized institutions addressed one pre-FDICIA concern – regulatory forbearance. In the 1980s and early 1990s, regulators worked with bank management of troubled institutions over an extended period of time to try to allow banks to grow out of their problems.

Overall, the implementation of section 38 was successful in limiting PCA banks’ access to high-risk funding, restricting asset growth, prohibiting dividends, and promptly closing critically undercapitalized institutions. However, as discussed next, the implementation of section 38 did little to resolve the problems of PCA banks during this crisis.

### **Inherent Limitations with PCA’s Capital-Based Framework and the Sudden and Severe Economic Decline Impacted PCA’s Effectiveness**

Earlier GAO and OIG reviews reported that although capital is an objective measure, it is an inherently lagging indicator of an institution’s operational and financial health and is dependent on accurate financial reporting. In one of its earlier reviews on PCA, GAO observed that once capital declines, it simply may be too late to prevent failure. Experience during this crisis is consistent with that observation – although PCA was appropriately implemented, nearly 60 percent of PCA banks failed and PCA banks accounted for 90 percent (291 of 325) of banks that failed. Further, the sudden and steep decline in economic conditions during this crisis impacted PCA’s effectiveness in terms of resolving the problems of troubled institutions. Figure 1 illustrates the status of the 489 PCA banks as of December 31, 2010.

**Figure 1: Status of 489 PCA Banks as of December 31, 2010**



Source: OIG analysis of data for PCA banks as of December 2010.

**Lagging Nature of Capital.** Congress chose to use capital as a trigger for section 38 regulatory action because it was “a strong, objective measure of an institution in trouble.”<sup>19</sup> Congress noted that “the better capitalized an institution is, the longer the period of time regulators will have to assess problems and resolve them.”<sup>20</sup> However, during this crisis, once an institution’s capital fell below minimum levels, the decline was precipitous, allowing little time for corrective actions to take effect. Specifically, institutions that fell below minimum regulatory capital requirements did not cascade through various capital levels. We reviewed data for 108 MLRs involving PCA banks and found that only 20 percent (22 of 108) triggered all three undercapitalized levels. Thirty-eight percent (41 of 108) triggered two undercapitalized levels, and 42 percent (45 of 108) only triggered one level of undercapitalization. Of those institutions that only triggered one PCA level, 20 institutions fell from well or adequately capitalized directly to critically undercapitalized.

A 1996 article written by economists at the Federal Reserve Bank of Boston, entitled *The Use of Capital Ratios to Trigger Intervention in Problem Banks: Too Little, Too Late*, considered whether the capital thresholds that trigger PCA intervention provide sufficient lead time for successful intervention at troubled

<sup>19</sup> Senate Rep. No. 102-167, p. 32 (Oct. 1, 1991).

<sup>20</sup> *Id.*

institutions. The study found that because PCA is based on a lagging indicator, it is likely to trigger intervention in problem banks only after problems have been identified by examiners.

**Dependence on Accurate Reporting.** The article also stated that reductions in reported leverage ratios associated with the deterioration in a bank's health are often delayed until the bank undergoes a supervisory examination. Banks tend to be slow to provision for possible loan losses (which, other things being equal, reduces their capital), often adding to loan loss reserves only after the problems have been identified, rather than in anticipation of problems. In fact, reported leverage ratios for troubled banks that have not been subjected to a supervisory examination often overstate the institution's financial health. Consequently, many banks experience a large reduction in their reported capital ratios as a consequence of requirements to charge off loans and replenish loan loss reserves that are imposed as a result of an examination.

As discussed in Section I of this report, a regulator's ability to take effective early corrective action and the degree to which early corrective action can make a difference depend on accurate and timely financial information. Often banks use overly optimistic loss projections and/or have difficulties properly valuing assets during a period of rapidly declining economic conditions. Based on our analysis, we found that Call Reports were slow to reflect rapidly declining asset values and therefore the true level of capital available to absorb losses, especially when overly optimistic bank projections did not materialize. Consequently, a significant number of Call Reports were amended, and the amendments generally resulted in decreased reported capital levels.

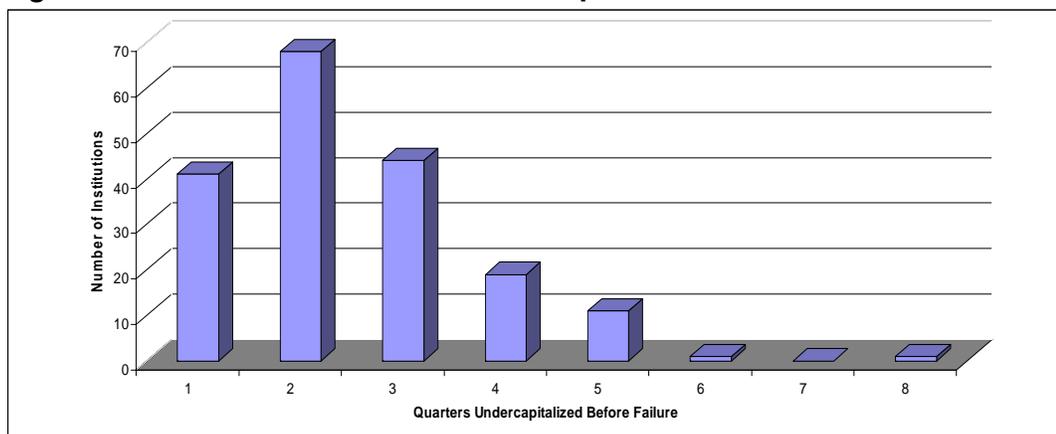
Between 2008 and November 2010, 43 percent of 4-rated and 50 percent of 5-rated FDIC-supervised institutions required material amendments to their Call Reports. With respect to FDIC PCA banks, 22 percent (69 of 314) had amended Call Reports. While some amendments were self-initiated, more often, they were based on examination findings that required increases to the allowance for loan and lease losses reserve to reflect asset quality problems, which in turn reduced capital.

**Sensitivity to Economic Decline.** Another factor impacting PCA's effectiveness, in terms of resolving the problems of institutions, was the steepness and suddenness in which the financial crisis

unfolded. The financial crisis began developing in the second half of 2007 and was followed by an accelerated sharp deterioration in 2008. Treasury’s 1991 study stated that an economic shock could impair the effectiveness of PCA. Specifically, the 1991 Treasury report noted that bank assets are inherently difficult to value, and even when market prices for those assets exist, economic shocks may cause a rapid change in those values, thereby limiting the FDIC’s ability to resolve an institution early enough to avoid a cost to the DIF.

Figure 2 illustrates how most PCA banks that failed became undercapitalized suddenly and severely and failed a median of 2 quarters after becoming undercapitalized. Regulators described this as the “cliff effect” of capital decline, which, as discussed in more detail below, was driven in part by the sudden and sharp economic decline.

**Figure 2: Number of Quarters Undercapitalized Before Failure**



Source: OIG analysis of capital levels for 185 bank failures between January 1, 2006 and March 31, 2010.

The economic decline during the 1980s was gradual and long, and likely helped shape the expectation embedded in section 38 that an institution would cascade through the various capital levels, allowing time for corrective action to take effect. The more recent financial crisis was different, and circumstances made it difficult for both institutions and regulators to determine rapidly declining asset values, especially for securities with no readily obtainable market value. Officials we interviewed in each of the regulatory agencies all agreed that PCA was not effective in terms of resolving the problems of troubled institutions during such a period of sharp nationwide economic decline. In their view, PCA is a better tool for individual banks during benign economic times.

For example, the Comptroller of the Currency remarked in July 2010 that PCA proved valuable during benign economic times, when banks with problems that took longer to play out really could be addressed earlier than they had been previously, avoiding costly failures. Indeed, the Comptroller viewed PCA as a contributing factor to the fact that there were no bank failures between June 2004 and February 2007. However, the Comptroller noted that PCA's record since then has proven to be less positive. During this period, he stated that declining capital levels of banks – on which PCA is fundamentally premised – lagged far behind the relatively sudden and large problems caused by troubled construction and development loans that precipitated failure. Further, of the 45 national banks that had failed between January 2008 and July 2010, nearly all had amounts of capital that significantly exceeded the PCA-required well capitalized level just 1 year before failure because loan charge-offs had not “spiked.” By the time the magnitude of the losses was recognized, regulatory intervention authorized under PCA was too late to avoid failures and losses to the DIF.<sup>21</sup>

### **Regulators Identified Deficiencies Prior to Undercapitalization**

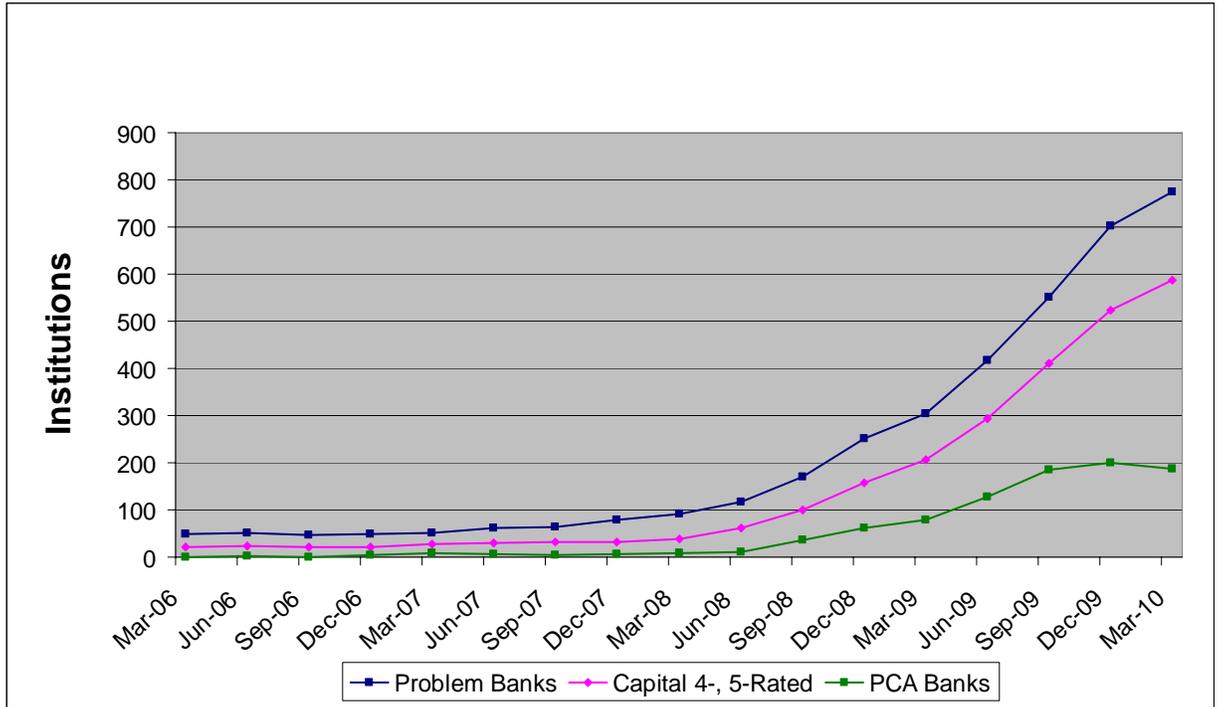
Regulators generally identified troubled institutions as problem banks (banks assigned CAMELS composite ratings of “4” or “5”) and downgraded the capital component rating before the banks became undercapitalized and mandatory PCA provisions came into play. We found that over the 4-year period we analyzed, only 11.5 percent (median) of problem banks were undercapitalized or lower for PCA purposes. Moreover, only 24 percent (median) of problem banks with a “4” (deficient) or “5” (critically deficient) capital component rating were undercapitalized or lower for PCA purposes.<sup>22</sup> Figure 3 presents, by quarter, the number of problem banks, banks with a capital component rating of “4” or “5,” and PCA banks.

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<sup>21</sup> Remarks made by Comptroller of the Currency July 21, 2010.

<sup>22</sup> This calculation represents the median of the percentage of Capital component 4- and 5-rated problem banks that were also undercapitalized, by quarter. The percentages ranged from a low of 4.5 percent for the quarter ended September 30, 2006 (i.e., 4.5 percent of the Capital component 4- or 5-rated banks were also undercapitalized during the quarter) to 45.1 percent for the quarter ended September 30, 2009.

**Figure 3: Comparison of the Number of Problem Banks, Banks with Deficient Capital Component Ratings, and PCA Banks**



Source: OIG analysis of FDIC data.

Note: At the FDIC’s request, PCA data is lagged by one quarter to account for Call Report amendments made by banks and/or examiners.

According to the Senate report on FDICIA, the PCA system was envisioned to require regulators to act at the “first sign of trouble.”<sup>23</sup> PCA was designed not only to limit regulatory forbearance by requiring the timely closure of failing banks but also by requiring earlier intervention in problem banks. In its 2007 report, GAO stated that regulatory action focused solely on capital may have limited effects because of the extent of deterioration that may have already occurred in other areas. Further, according to that report, regulators generally agreed that PCA, by design, is not a tool that can be used upon early recognition of an institution’s troubled status.

**Identification of Problem Banks.** In most cases, PCA is not triggered at the “first sign of trouble.” Rather, PCA supplements existing supervisory guidance, and regulators stated that PCA serves as a “backstop” or a safeguard to be used if other enforcement actions are bypassed or delayed. During the period of our review, 61 percent (679 of 1,122) of the problem banks

<sup>23</sup> Senate Rep. No. 102-167 p. 32 (Oct. 1, 1991).

were never undercapitalized. With respect to the PCA banks, approximately 49 percent of PCA banks were designated as problem banks before the institution’s capital level fell below required minimums, and another 17 percent became undercapitalized and were included on the problem bank list during the same quarter.

We also analyzed the timing of ratings downgrades and PCA levels for 120 failed banks for which MLRs were completed. We found that examiners downgraded banks to a “4” or a “5” composite rating a median of 275 days prior to failure. Conversely, banks became undercapitalized a median of 107 days prior to failure.

Further, we reviewed problem bank memoranda for our sample of 118 well and adequately capitalized problem banks and 111 PCA banks to better understand what prompted supervisory concern for these institutions. As discussed, our sample included institutions that ultimately failed. As shown in Table 5, we found that asset quality and management issues were the leading indicators of whether a bank would become a problem bank, become undercapitalized, or fail. Asset quality and management issues were also often found to be the leading indication of problem banks and capital depletion in the 1980s.

**Table 5: Areas of Concern Identified in Problem Bank Memoranda**

Area of Concern Identified by Examiners	Results of Analysis for Sample of PCA Banks		Results of Analysis for Sample of Problem Banks	
	Number	Percentage of Sample	Number	Percentage of Sample
Capital	44	40%	57	48%
Asset Quality	109	98%	106	90%
Management	97	87%	111	94%
Earnings	43	39%	86	73%
Liquidity	50	45%	51	43%
Sensitivity to Market Risk	5	5%	1	1%

Source: OIG review of problem bank memoranda for our sample of 111 PCA and 118 problem banks.

We also reviewed other available information for these banks, including examination reports and MLR reports (if applicable), to help us more specifically identify the common problem areas within asset quality and management. We found asset quality concerns frequently involved loan concentrations coupled with high levels of adversely classified assets and inadequate risk management practices (i.e., poor underwriting and credit administration). The most common issues associated with

management were inadequate board and management supervision and weak internal controls.

In addition to our analysis of sampled items, we reviewed other articles/publications to further validate the underlying causes attributed to the universe of problem, PCA, and failed banks. For example, an article in the FDIC's *Supervisory Insights Journal*, entitled, *A Year in Bank Supervision: 2008 and a Few of its Lessons*, stated that the majority of community banks that became problem banks or failed in 2008 had similar risk profiles. These banks often had extremely high concentrations, relative to their capital, in residential acquisition, development, and construction lending. Loan underwriting and credit administration functions at these institutions typically were criticized by examiners. Frequently, these institutions had exhibited rapid asset growth funded with brokered deposits. With respect to larger banks, substantial losses to the DIF in 2008 came from portfolios of low- and no-documentation subprime and Alt-A mortgage loans (a type of mortgage between prime and subprime) and securities backed by such loans.

The 1996 article discussed earlier in this report, entitled *The Use of Capital Ratios to Trigger Intervention in Problem Banks: Too Little, Too Late*, also found that examiners often were aware of problems well before a bank became undercapitalized as defined by the PCA provisions. The study also found that in many cases, banks failed shortly after falling below the PCA undercapitalized thresholds before any serious attempt could be made to alter bank behavior. The study concluded that PCA triggers that more closely mimic the timing of problem bank identification by examiners would result in more timely intervention in problem institutions.

**Identification of Capital Deficiencies.** Examiners often rated a problem bank's capital level as deficient or critically deficient, based on the bank's risk profile, before the bank became undercapitalized for PCA purposes. Capital problems are most frequently caused by losses from bad loans or bank operations. An institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The types and quantity of risk inherent in an institution's activities determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to

properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

The capital adequacy of an institution is rated based on an assessment of a number of factors, including (1) the level and quality of capital; (2) management's ability to address capital needs and access capital markets and other sources of capital, including the support provided by a parent holding company; (3) the nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves; (4) the balance sheet composition, including the nature of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities; (5) the quality and strength of earnings and the reasonableness of dividends; (6) the prospects and plans for growth as well as past experience managing growth; and (7) the risk represented by off-balance sheet activities.

Based on our sample of 118 problem banks, we found that 56 percent (66 of 118) had a "4" or "5" capital component rating, signifying a deficient or critically deficient level of capital that could threaten the bank's viability, but these institutions were not PCA banks (i.e., undercapitalized). Although these results indicate that examiners proactively identified issues before their capital levels fell below regulatory minimums – the results are contrary to the expectation that PCA would require regulators to act at the "first sign of trouble."

### **Regulators Used Other Enforcement Actions to Respond to Safety and Soundness Concerns Before Undercapitalization, but After Financial Decline Occurred**

Most of the PCA banks (86 percent) and problem banks (96 percent) in our samples had formal enforcement actions in place. Based on our review of failed banks, regulators imposed formal enforcement actions before banks became undercapitalized. However, MLR reports often concluded that, although regulators identified the risks at failed institutions, in hindsight, earlier supervisory concern and intervention would have been prudent. The results of our MLRs indicate that CAMELS ratings for the failed financial institutions placed greater emphasis on a bank's financial condition at the time of the examination and on the bank's levels of capital and earnings, rather than the bank's ability to successfully mitigate identified risks. Similar to the lessons

learned from the 1980s and early 1990s, these results suggest that the ability of regulators to curb excessive risk-taking when the risky behavior was profitable (i.e., before financial condition deteriorated), continues to be a challenge despite implementation of PRA provisions designed to address this issue.

As mentioned earlier in this section of the report, regulators typically rely on onsite examinations and offsite monitoring to monitor the practices and conditions of banks. When unsafe and unsound banking practices or conditions are identified, regulators have the authority to use a variety of enforcement actions prescribed by law and banking regulations to compel the banks to address the identified problems. These actions range from informal meetings to formal actions that are enforceable in courts. Informal actions are voluntary commitments made by a bank's Board of Directors that document management agreement to corrections through commitment letters or memorandums of understanding. Informal actions are not legally enforceable and are not available to the public. Stronger, formal actions available include formal written agreements; orders to cease and desist unsafe practices; orders for removal, prohibition, and suspension of individuals from bank operations; and civil monetary penalties. Formal actions are legally enforceable, and final formal orders are available to the public after issuance.

Formal and informal actions address practices, conditions, or violations of law that, if continued, could result in risk of loss or other damage to an insured financial institution. To mitigate loss or other damage to an institution, regulators try to secure correction of objectionable practices as soon as possible. When unacceptable practices are detected early, moral suasion and informal action against an institution are generally considered sufficient. However, in more serious situations, formal action could be considered even for institutions that receive composite ratings of "1" or "2" for safety and soundness or compliance examinations to address specific actions or inactions by an institution.

With respect to our sample of 111 PCA banks, 7 percent had informal actions in place, 86 percent had formal enforcement actions in place, and 1 percent failed without any action in place. In five instances, regulators did not pursue an enforcement action because the institutions were either merged or were undercapitalized for only one quarter. The problem bank sample

of 118 institutions showed similar results. A total of 96 percent of the problem banks had formal actions, and 4 percent had informal actions. Table 6 summarizes the results of our analysis.

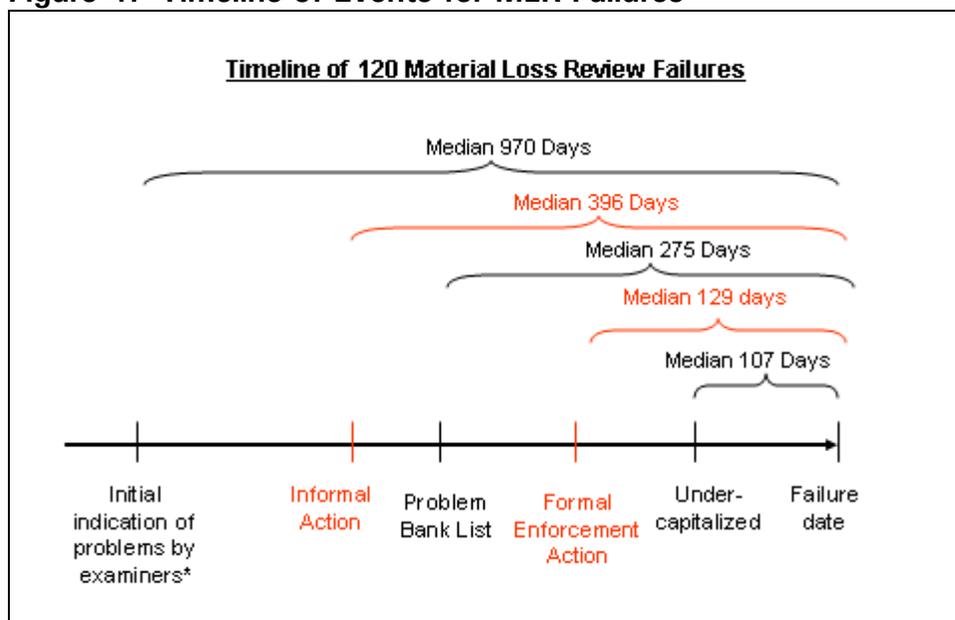
**Table 6: Analysis of Enforcement Action Activity for OIG Sampled Banks**

Nature of Enforcement Action	OIG Sample			
	PCA Banks		Problem Banks	
	Number	Percentage	Number	Percentage
Informal Action	8	7%	5	4%
Informal Action and Subsequent Formal Action	49	44%	40	34%
Formal Action	47	42%	73	62%
Action Initiated/Proposed but Not Complete	2	2%	0	0%
No Action	5	5%	0	0%
<b>Totals</b>	<b>111</b>		<b>118</b>	

Source: OIG analysis of enforcement actions taken or initiated for OIG sample of PCA and problem banks.

In order to determine when informal and formal actions were implemented, we developed a timeline to illustrate the steps regulators generally took to identify and address safety and soundness concerns. Our timeline illustrated in Figure 4 is based on our review of 120 MLR reports for banks that failed between January 2006 and March 2010, as those reports provided a complete analysis of supervisory actions from the time an underlying problem was first identified until failure.

**Figure 4: Timeline of Events for MLR Failures**



Source: OIG analysis of supervisory data for MLRs completed between January 2006 and March 2010.

\*Initial indication of problems by examiners was generally the date of the examination in which examiners identified problems in the bank that ultimately contributed to the bank's failure.

Regulators identified underlying risks well in advance of failure; however, as discussed in a recent FDIC OIG report summarizing its MLRs, CAMELS ratings for the failed financial institutions placed greater emphasis on a bank's financial condition at the time of the examination and levels of capital and earnings, rather than the bank's ability to successfully mitigate identified risks. As a result, regulators often did not pursue formal enforcement action until an institution's financial condition was impacted.<sup>24</sup> Although the CAMELS rating system contains explicit language in each of the components emphasizing management's ability to identify, measure, monitor, and control risks, examiners did not always place sufficient emphasis on risk mitigation when assigning ratings. Further, management's lack of responsiveness to examiners' concerns was not always reflected in assigned CAMELS ratings until significant financial deterioration had occurred. Examiners frequently explained that it was their perception that the apparent financial strength of an institution, expressed in earnings and capital, limited their options for addressing elevated risk profiles. As discussed in individual MLRs

<sup>24</sup> *Follow-up Audit of FDIC Supervision Program Enhancements*, (FDIC OIG Report No. MLR-11-010) issued in December 2010.

and summary reports on MLR findings, regulators have begun to incorporate lessons learned from this financial crisis into their regulatory processes, including findings from MLRs. However, it is too soon to tell whether the processes will be effective and sustainable in the long term.

The notion of having evidence of financial deterioration before pursuing an enforcement action is the same issue regulators struggled with during the 1980s and early 1990s. As noted by the FDIC in the *History of the Eighties – Lessons for the Future*, bank regulators had difficulty restricting the behavior of ostensibly healthy banks while the banks were still solvent and the risky behavior was widely practiced and currently profitable. The study concluded that it was hard to distinguish such behavior from acceptable risk/return trade-offs, innovation, and other appropriate activity, or to modify the behavior of banks while they were still apparently healthy. Examiners stated that as long as a bank was profitable, it was difficult to persuade bank management or regulatory supervisors that problems could lie ahead.

### **Regulators Made Limited Use of Section 39 to Address Deficiencies Identified**

Similar to findings in earlier reviews of PRA provisions, with the exception of the OCC, regulators rarely used section 39 during our sample period, opting instead to take informal as well as formal enforcement actions using their authority under section 8 of the FDI Act. As discussed in Section I of this report, changes to section 39 in 1994 gave regulators considerable flexibility over how and when to use their authority under this section to address safety and soundness deficiencies. Section 39 was intended to allow regulators to take action against seemingly healthy banks that were engaging in risky practices before losses occurred. Existing regulatory guidance states that section 39 actions can be initiated for non-problem institutions in which inadequate practices and policies could result in a material loss to the institution or in cases where management has not responded effectively to prior criticisms.

According to FDIC enforcement action guidance, the *Interagency Guidelines Establishing Standards for Safety and Soundness* are designed to prompt institutions to take steps that will help identify emerging problems and correct deficiencies before the safety and soundness of the institution becomes impaired. Additionally, the

guidance states that an institution should not be viewed as having failed one of the standards due to an isolated error or inconsistency; instead, the FDIC should assess the institution's overall practices and performance in each area when determining whether the institution satisfies the standards.

According to regulatory guidance related to enforcement actions, under section 39, the regulatory agency may request an institution to submit a compliance plan describing the steps the institution will take to correct the identified deficiencies.<sup>25</sup> This is considered to be an informal action. Institutions that fail to submit an acceptable plan, or materially fail to adhere to the submitted plan, become subject to an order requiring correction of the deficiencies noted, which is considered a formal action. Proceeding under section 39 has several advantages: (1) a compliance plan can be obtained within 30 days, (2) the order is enforceable in federal court without a hearing, and (3) consent is not required. However, once a section 39 order is initiated, regulators told us that they lack the discretion to avoid issuing a formal order if an acceptable compliance plan is not submitted or not materially implemented. Further, a stipulated formal order under section 8(b) potentially can be implemented and enforcement actions can be available faster than issuing a section 39 order because of the requirements related to providing notice and allowing time for the institution to respond. GAO has reported in its earlier reviews that section 39, as amended, does not appear to significantly change the wide discretion that regulators have regarding the timing and severity of enforcement actions taken against troubled institutions.

OCC required 21 institutions to submit compliance plans under section 39 to address safety and soundness concerns from January 2006 through March 2010.<sup>26</sup> In most cases, OCC required compliance plans to address asset quality, credit risk management, credit underwriting, loan documentation, and internal control issues. OCC requested compliance plans from five institutions to address CRE concentrations or asset growth and from three institutions to address Bank Secrecy Act concerns. OCC imposed subsequent formal enforcement actions on 4 institutions, and 5 of the 21 institutions later merged or failed. Most of the institutions were "3-rated" at the time of section 39

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<sup>25</sup> FDIC *Formal and Informal Action Procedures Manual* p. 11-5.

<sup>26</sup> OCC required compliance plans from an additional seven institutions through March 2011.

action, and most are currently “3-rated” as of their most recent examination.

The FDIC initiated section 39 actions on two occasions between 2006 and 2010. In January 2006, the FDIC requested that one institution submit a section 39 compliance plan to address inadequate loan documentation, concentrations of credit, and poor performance of collateral. In March 2006, the compliance plan request was replaced with a formal cease and desist order covering additional concerns. The institution was released from that order in November 2007. In 2009 and 2010, the FDIC issued section 39 actions to 15 banks controlled by a single troubled holding company. The actions required each individual bank to submit a detailed plan to sell, merge, or sufficiently capitalize the bank.

Regulators stated that they preferred using other informal actions like Bank Board Resolutions or Memoranda of Understanding and/or section 8 authority to take a formal enforcement action. Regulators explained that, in their view, these actions serve the same purpose as an action under section 39 and could be implemented more timely. In addition, some regulators commented that because the safety and soundness standards issued under section 39 constitute guidance and not a regulation, they can potentially be more difficult to enforce. The agencies adopted the standards as guidelines to grant each institution the flexibility of developing appropriate procedures based on the scope and nature of its activities. One official acknowledged that section 39 could be used more to address concerns given it establishes very broad safety and soundness standards, but the process for doing so would be subjective.

### **Critically Undercapitalized Institutions Were Closed Promptly, but Overall Losses Were Significant**

The Senate report accompanying FDICIA predicted that the “[PCA] system will help shift the costs of failures toward the shareholders of troubled institutions, away from the deposit insurance system and the taxpayers.”<sup>27</sup> An FDIC publication on PCA noted that “[m]any economists expected these [the PCA] provisions to result in dramatically reduced loss rates, or even zero loss rates for bank

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<sup>27</sup> Senate Rep. No. 102-167, p.32 (October 1, 1991).

failures.”<sup>28</sup> Preliminary cost data suggests that institutions were closed before capital levels were depleted, but losses as a percentage of assets are higher in comparison to losses in the 1980s and early 1990s. The degree of losses experienced during this crisis contributed to the depletion of the DIF, which had a negative balance of \$7.4 billion as of December 31, 2010.

As discussed, the 117 critically undercapitalized institutions were closed promptly as required. We analyzed capital levels one quarter before failure for failed institutions in the current crisis against the capital level of failed institutions for the same period during the 1980s and early 1990s. We found that institutions failing during the current crisis had more capital available to absorb losses than during the 1980s and early 1990s. Failed institutions at this point in the crisis had a median equity-to-asset ratio of 1.76 percent, while institutions that failed between 1980 and 1994 had a ratio of negative 1.03 percent.

Unfortunately, imbedded loan losses and declines in asset values far exceeded failed banks’ reported equity, resulting in significant losses to the DIF. When a bank fails, the FDIC engages an independent financial advisor to perform an asset valuation review to assign market values to various categories of bank assets. We reviewed information for 190 failed banks and identified a median asset valuation discount of 36 percent from the asset values that the failed banks reported on their books and records. Overall, these banks’ asset book values at the time of failure totaled \$175 billion, and the FDIC discounted the value of those assets by a total of \$64.7 billion.<sup>29</sup>

Accordingly, the cost of failure from the 325 banks that failed between 2006 and 2011 was significant and is currently estimated to be \$82.4 billion.<sup>30</sup> Table 7 compares overall loss rates for commercial banks and thrifts for the two periods discussed above.

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<sup>28</sup> *Differentiating Among Critically Undercapitalized Banks and Thrifts in Prompt Corrective Action in Banking: 10 Years Later*, FDIC Banking Review, Vol. 15, No. 2 (2003).

<sup>29</sup> This discounted value represents the amount that the FDIC estimates the failed bank asset would be worth if the FDIC had to immediately liquidate the assets at the time of failure. In most cases, the FDIC enters into Shared-Loss Agreements, which protect assuming institutions against most of the future losses associated with acquired assets but limit the assuming institution from selling the assets until they recover in value. Theoretically, the assuming institutions pay the FDIC a greater price for the failed bank assets, representing the assets’ “intrinsic value” as opposed to the price that the FDIC would receive by liquidating the assets in a depressed economy.

<sup>30</sup> FDIC cost estimate as of May 17, 2011.

**Table 7: Overall Loss Rates for Banks and Thrifts**

<b>Period</b>	<b>All Failures</b>	<b>Banks</b>	<b>Thrifts</b>
1980 through 1994	20.61%	11.42%	25.40%
2006 through 2010	25.02%	25.05%	24.94% *
Percent Change	21.40%	119.35%	-1.81%

Source: OIG analysis of FDIC's Failure Transaction Database.

\*Excludes Washington Mutual Bank. Washington Mutual Bank was the largest bank failure in history but resulted in no loss to the DIF because the FDIC facilitated the sale of the bank to JPMorgan Chase & Co.

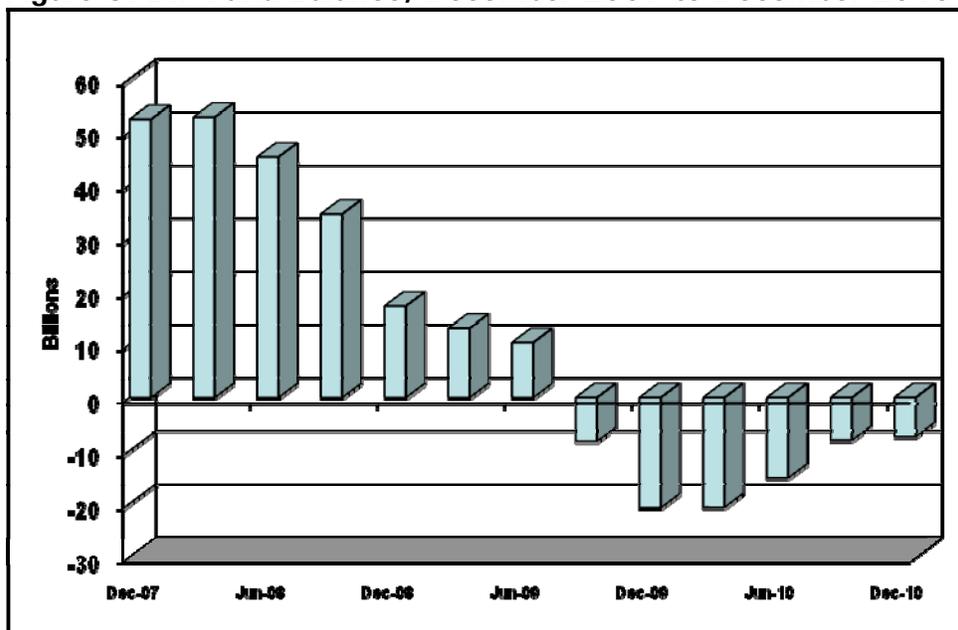
As illustrated, DIF loss rates were 21.40 percent higher during the current crisis than during the 1980s and early 1990s. Further, many bank failures since January 1, 2006, required an MLR because of the significant losses suffered by the DIF. FDIC officials caution against making loss rate comparisons between the two crises because current loss estimates are the FDIC's best guess of net losses and recoveries that could occur over the next 5 to 10 years.<sup>31</sup>

As a result of the losses from banks failing during the current crisis, the DIF decreased significantly, falling to a negative balance in the third quarter of 2009, as shown in Figure 5.

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<sup>31</sup> The FDIC shared-loss agreements mentioned previously include 5- to 10-year loss and recovery periods that may complicate the FDIC's ability to estimate bank failure losses.

**Figure 5: DIF Fund Balance, December 2007 to December 2010**



Source: December 31, 2010 Quarterly Banking Profile.

The DIF is funded by insurance premiums paid by banks. Since 1991, the FDIC has been required to employ a risk-based premium system for assessing banks for deposit insurance. As such, premiums are based on an institution's probability of causing a loss to the DIF due to the composition and concentration of the institution's assets and liabilities, the amount of loss given failure, and the revenue needs of the fund. Deposit insurance assessments are collected after each quarter ends. In previous reports involving two large bank failures, we reported that the existing assessment rules did not result in the collection of sufficient deposit insurance premiums to address the risks to the DIF presented by the two institutions.<sup>32</sup>

We also determined the insurance premiums assessed to and paid by the 10 institutions that represented the costliest failures for the FDIC during our period of review. Collectively, these 10 banks held assets of \$137.6 billion and cost the DIF \$36.1 billion in failure costs, roughly 44 percent of the total loss to the DIF during the period January 2006 through December 2010. Consistent with existing deposit insurance rules, the FDIC assessed \$385.2 million to cover the period from 2004 through 2011

<sup>32</sup> *The FDIC's Role in the Monitoring of IndyMac Bank* (FDIC OIG Report No. EVAL-09-006) issued in August 2009 and the *Evaluation of Federal Regulatory Oversight of Washington Mutual Bank* (FDIC and Treasury OIG Report No. EVAL-10-002) issued in April 2010.

(1.07 percent of the loss amount), and these 10 banks paid \$243.5 million during this period (0.67 percent of the loss amount).<sup>33</sup>

In an effort to restore fund liquidity, the FDIC Board required insured institutions in November 2009 to prepay assessments for a 3-year period (totaling approximately \$45 billion). Also, as discussed later, the Dodd-Frank Act mandated changes to the assessment base that the FDIC uses to calculate insurance premiums. The FDIC has issued final rules to implement the Dodd-Frank Act and to better price for large bank insurance risk.<sup>34</sup>

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<sup>33</sup> These 10 banks also received legislatively mandated deposit insurance credits of \$40 million, which offset their assessed amount.

<sup>34</sup> Large banks are defined as those with \$10 billion or more in assets.

## SECTION III

# Prompt Regulatory Action: Leading Indicators and Matters for Consideration

## **PRA: Leading Indicators and Matters for Consideration**

Experience during this recent crisis demonstrates that one of the fundamental lessons from the 1980s and 1990s remains valid – early intervention is the key to successfully resolving the problems of troubled institutions – and intervention must occur before an institution experiences financial and capital declines. This lesson may become more difficult to apply once the economy improves and banks return to profitability. Examiners will again be challenged in trying to address risky behavior by ostensibly healthy institutions. Going forward, the question is how to effectively address safety and soundness concerns prior to financial deterioration in order to avoid, or at least lessen, significant failures and losses emanating from a future crisis.

### **Ongoing Regulatory Responses to the Financial Crisis**

The Congress and federal banking regulatory agencies have responded to the financial crisis by planning and undertaking numerous initiatives to strengthen regulatory oversight. These efforts include the landmark Dodd-Frank Act and internal initiatives by the banking agencies. Further, in June 2011, GAO issued a study of PCA with recommended actions for the banking agencies.

The Dodd-Frank Act implements changes that, among other things, affect the oversight and supervision of financial institutions, provide for a new resolution procedure for large financial companies, create a new agency responsible for implementing and enforcing compliance with federal consumer financial laws, introduce more stringent regulatory capital requirements, effect significant changes in the regulation of over-the-counter derivatives, reform the regulation of credit rating agencies, implement changes to corporate governance and executive compensation practices, incorporate limitations on proprietary trading, require registration of advisers to certain private funds, and effect significant changes in the securitization market. The Dodd-Frank Act also established the Financial Stability Oversight Council, comprised of representatives from the financial regulatory agencies and chaired by the Secretary of the Treasury, to identify threats to the financial stability of the United States; promote market discipline; and respond to emerging risks to the stability of the financial system. The Dodd-Frank Act requires the regulators to publish numerous rulemakings to

implement its provisions, including provisions related to minimum capital requirements and deposit insurance assessments.

The regulators have begun to incorporate a number of lessons learned from the financial crisis into their regulatory processes, including those emanating from the MLR reports. Regulators have recognized the need to re-emphasize a supervisory approach that encompasses consideration of an institution's risk profile in all facets of the examination process. For example, the purpose of the FDIC's *Lessons Learned from the Crisis* initiative is to build upon the strengths of the supervision program, emphasize balanced and timely response to weak management practices and identified risks, and emphasize a more proactive approach to examination analysis and ratings based upon the lessons learned from recent failures. Although the new emphasis is a step in the right direction, sustaining long-term improvement depends on not forgetting the lessons learned once the economy and banking industry improve.

In June 2011, GAO issued a report to Congressional Committees, entitled *Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness* (GAO-11-612). GAO concluded that weaknesses in the current PCA framework stem primarily from tying mandatory actions to only capital-based indicators. GAO assessed the utility of various financial indicators in predicting bank distress by developing a model of leading indicators of bank failures based on financial ratios that researchers identified in the 1990s that predicted bank failures in previous stress periods. GAO found that non-capital measures – earnings, liquidity, asset quality, and asset concentration risk – were statistically and practically significant predictors of bank failure during the current crisis period.

GAO also surveyed 29 informed stakeholders from regulatory agencies, research organizations, and the banking industry regarding whether PCA should be changed and, if so, to rank broad options to make PCA more effective in minimizing losses to the DIF. Most stakeholders (79 percent) said that PCA should be modified and preferentially ranked the following top three options to make the PCA framework more effective:

- Incorporate an institution's risk profile (e.g., asset concentration exposure) into the PCA capital category threshold.

- Raise all of the PCA capital category thresholds.
- Include an additional trigger to PCA (e.g., a non-capital factor related to asset quality or liquidity).

GAO noted that any changes to the PCA framework would entail some tradeoffs and would require striking the right balance between more corrective actions and unnecessary intervention in healthy banks. GAO recommended that the banking agencies consider the three options and work through the Financial Stability Oversight Council to make recommendations to Congress on how PCA should be modified. The banking agencies agreed with GAO's recommendation.

### **Non-Capital Leading Indicators of Bank Problems**

As discussed in this report, our findings are consistent with those reported in GAO's June 2011 report. That is, capital is a lagging indicator of troubled institutions and numerous other factors are better leading indicators of potential troubles and may strengthen the PRA framework if used as triggers for mandatory regulatory intervention. These factors are not new. GAO first suggested many of the factors in 1991 as part of its proposed tripwire approach, and examiners at the regulatory agencies consider them during safety and soundness examinations. However, as discussed in Section II of this report, although examiners generally identified risk factors early, regulators often did not take formal corrective action until institutions experienced financial problems. Common risk factors identified in the earlier crisis or the current crisis can be categorized as follows:

- High-risk business strategies — such as aggressive growth; asset concentrations; speculative, out-of-territory lending and high-risk lending (high loan-to-value, non-traditional lending); dependence on volatile funding sources; and excessive exposure to interest rate risk.
- Risk management weaknesses — such as board, management, and corporate governance weaknesses; poor executive compensation practices; inadequate lending policies; poor underwriting practices; poor credit administration practices; inadequate loan documentation; and inadequate staffing or infrastructure.

- Regulatory compliance and responsiveness — such as violations, recommendations, lack of responsiveness to examiner findings, and repeat findings.
- Asset quality or earnings deterioration — credit problems such as classified or non-performing assets, poor return on assets and return on equity, and declines in stock valuation.

High-risk business strategies and risk management weaknesses often occur years in advance of financial decline or capital depletion. Taking formal regulatory action at the point that these weaknesses are identified would likely yield better results. Accordingly, greater use of risk factors associated with these weaknesses is one option for strengthening PRA, as discussed next.

### **Matters for Consideration**

The PRA provisions were intended to supplement existing regulatory enforcement tools. Accordingly, we evaluated regulators' use of these supplemental enforcement tools and other supervisory actions to help assess PRA's effectiveness and identify areas for improvement. In that regard, the following considerations are available to the banking agencies that could potentially strengthen, or indirectly support, the PRA provisions: (1) develop specific criteria and corresponding enforcement actions for non-capital factors, (2) increase the minimum PCA capital levels, and (3) continue to refine the deposit insurance system to assess greater premiums commensurate with risk-taking. We recognize that in evaluating these matters there may be differences with respect to large and small institutions.

**Develop Specific Criteria and Corresponding Enforcement Actions for Non-Capital Factors.** As discussed in this report, PCA capital triggers proved to be too late to rehabilitate troubled institutions, and regulators generally waited until financial deterioration had occurred to enforce safety and soundness standards even though examiners frequently identified non-capital risk factors well in advance of financial and capital decline.

Under this option, the regulators would develop (1) specific non-capital factors or standards that correspond to the high-risk business strategies or risk management practices and asset quality and earnings-related leading indicators discussed earlier and

(2) corresponding enforcement actions, such as limiting an institution's growth, restricting the interest rates paid on deposits, or requiring the institution to increase capital until the deficiency is corrected.

A clear candidate for a more definitive, regulatory standard is asset growth, which, when aggressive, can strain or exacerbate existing weaknesses in a bank's risk management and credit administration process. Such conditions often result in excessive concentrations of poor quality assets. For example, excessive concentrations in commercial real estate or mortgage loans factored significantly in the majority of failing banks for which the Inspectors General conducted MLRs. Other regulatory standards could be developed related to net non-core funding dependence (volatile funding dependence) and non-performing and delinquent loans.

We understand that examiners already have internal benchmarks (e.g., classified asset levels) that they use to support downgrading examination ratings and pursuing supervisory action. We also note that Treasury used specific ratio limits related to classified assets, non-performing loans, and construction lending under the Troubled Asset Relief Program (TARP) Capital Purchase Program to assess institution applicants' viability for TARP funding. Thus, there is some precedent for using such benchmarks or limits.

Regulators may also want to revisit developing qualitative measures for risk factors such as loan underwriting and quality of management. We understand that it might be difficult to reach agreement on such measures, due to their subjectivity; however, such qualitative factors were leading indicators of problems in many banks that failed during the recent crisis.

The section 39 safety and soundness standards provide an existing framework for establishing non-capital risk factors. As discussed in section I of our report, FDICIA required the federal banking agencies to establish operational and managerial standards. The regulators had great difficulty establishing and agreeing on safety and soundness benchmarks for section 39 during the early 1990s. As a result of concerns about regulatory burden on the banking industry, 1994 legislation eliminated the requirement to establish quantitative standards. The resulting safety and soundness standards are broad principles of sound banking that are subject to considerable interpretation by the

regulators. While the standards identify general controls and processes the regulators expect institutions to have, the standards do not provide specific, measurable criteria of unsafe conditions or practices that would trigger mandatory enforcement actions.

The regulators could develop a new framework of non-capital factors. Any framework should present specific standards or factors, include corresponding mandatory enforcement measures, and, preferably, be grounded in regulation. Alternatively, the regulators could revisit section 39 and reissue more specific standards as regulations.

Advantages of this option are that it would provide the regulators with an additional enforcement tool that is not dependent on financial decline. It also reduces the discretion of regulators and forces them to take formal enforcement action in the event that a bank does not implement a corrective plan. Firm, specific standards would also provide the industry with clarity on when regulators would begin pursuing formal action and provide examiners with a clearer basis for examination ratings and supervisory actions, regardless of whether a bank is profitable. In this regard, regulators told us that one benefit of PCA is that everyone – the banking industry, investors, and examiners – has a common understanding of the rules and the implications when minimum capital levels are breached.

We understand that it may be difficult for regulators to agree on non-capital factors that should be considered for enforcement. Regulators also expressed concern that the banking industry will quickly identify loopholes or find ways around “bright-line” regulatory limits, and regulators’ ability to quickly adapt to banking industry efforts to circumvent non-capital factors or standards could be impaired. Regulators also view section 39 enforcement actions as duplicative of other formal enforcement actions, and stated they can accomplish what they need to with consent orders. However, as noted in this report, regulators must have the willingness to use enforcement actions in controlling risky, but otherwise profitable institutions, and regulators did not display this willingness during the time leading up to the past two banking crises.

**Increase the Section 38 Capital Thresholds.** The financial ratios used to define section 38 undercapitalization categories were established by regulation in 1992 and have remained unchanged

since that time. The current crisis indicates that many institutions became undercapitalized suddenly and severely, and the resulting section 38 mandatory actions had little time to resolve the problems of an institution. Higher capital floors for the undercapitalized and significantly undercapitalized categories (the critically undercapitalized level is statutory) may provide more time for mandatory actions to take effect and rehabilitate troubled institutions. As discussed in Section II, a 1996 study by FRB economists concluded that raising the leverage ratio threshold that triggers mandatory PCA intervention from 4 percent to 5 percent would cause PCA to more closely mimic the timing of problem bank identification by examiners.<sup>35</sup> Given the losses to the DIF from the recent crisis, Congress may also wish to revisit the statutory 2-percent critically undercapitalized threshold to provide an increased capital buffer to further shift the cost of failure to shareholders rather than the DIF.

As discussed in Section II, the Dodd-Frank Act strengthened capital in the banking industry, and the Basel Committee on Banking Supervision recently released guidelines recommending increased capital requirements to be phased in by January 1, 2015 (Basel III).<sup>36</sup> The banking agencies are also developing rules to implement Basel III proposals for raising the quality and quantity of regulatory capital and setting new liquidity standards. The agencies issued a Notice of Proposed Rulemaking in January 2011 that proposes to implement the Basel Committee's 2009 revisions to the existing market risk capital rule, and the agencies are planning to issue a Notice of Proposed Rulemaking later in 2011 that will seek comment on plans to revise the risk-based capital guidelines to implement Basel III increased capital requirements.

Advantages of this option are that increased capital levels would create an incentive for banks to hold greater amounts of capital, and banks would be in a better position to absorb losses, withstand borrower defaults, and remain solvent. Using higher capital levels as triggers should also result in examiners identifying and addressing troubled banks earlier and lower bank failure costs to the DIF. However, banks will likely find it more expensive to hold additional capital and might limit lending or charge more for credit as a result. Further, higher capital levels might result in

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<sup>35</sup> The Use of Capital Ratios to Trigger Intervention in Problem Banks: Too Little, Too Late, September/October 1996, New England Economic Review.

<sup>36</sup> *Basel III: A global regulatory framework for more resilient banks and banking systems*, Basel Committee on Banking Supervision (Dec. 2010).

regulatory intervention in the operation of otherwise healthy banks.

**Continue to Refine the Deposit Insurance System to Assess Greater Premiums Commensurate with Risk-Taking.** As discussed in Section II, the existing deposit insurance rules did not allow the FDIC to assess or collect insurance premiums sufficient to address the losses caused by the costliest failures.

In response to the crisis, the Congress and the regulators have taken steps to make the deposit insurance system more risk-based. For example, the Dodd-Frank Act directed the FDIC to amend its regulations to redefine the deposit insurance assessment base from average domestic deposits to average total consolidated assets minus average tangible equity.<sup>37</sup> This change will expand the base on which deposit insurance premiums are calculated, especially for larger institutions. In February 2011, the FDIC amended the deposit insurance regulations to implement the assessment base changes and revise the assessment system for large insured depository institutions.<sup>38</sup>

The implementing regulations amend the assessment system applicable to large insured depository institutions to better capture risk at the time the institution assumes the risk, to better differentiate risk among large insured depository institutions during periods of good economic and banking conditions based on how they would fare during periods of stress or economic downturns, and to better take into account the losses that the FDIC may incur if a large insured depository institution fails. Going forward, assessments for large banks will be calculated using a scorecard that combines CAMELS ratings and certain forward-looking financial measures to assess the risk a large institution poses to the DIF. These financial measures include scorecard measures related to:

- a bank's ability to withstand asset-related stress – which includes a higher-risk asset concentration measure, the ratio of

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<sup>37</sup> This change expanded the base on which assessments are calculated to include non-domestic deposit liabilities such as foreign deposits and other secured liabilities and will result in larger banks paying proportionately more for deposit insurance because those liabilities were not previously included in the assessment base.

<sup>38</sup> The final rule generally defines a large institution as one having assets of \$10 billion or more (76 Fed. Reg. 10672 Feb. 25, 2011).

earnings to assets, and a classified or underperforming asset ratio;

- a bank's ability to withstand funding-related stress – which includes a core deposits to total liabilities ratio and a balance sheet liquidity ratio that measures the amount of highly liquid assets needed to cover potential cash outflows in the event of stress; and
- a loss severity score – which estimates the relative magnitude of potential losses to the FDIC in the event of a large institution's failure.

The changes to the assessment base and large-bank pricing system should allow the FDIC to better price deposit insurance for risk, especially for large institutions.

For smaller institutions, however, the assessment rates continue to be based on a combination of the bank's capital levels and supervisory ratings, consisting of an institution's weighted CAMELS component ratings and selected financial ratios (including ratios related to past due loans, nonperforming assets, net loan charge-offs, net income before taxes, and Tier 1 leverage capital). Institutions in higher risk categories may also face an adjustment related to brokered deposit levels.

Nine of the 325 banks that failed during our sample period were large banks with assets over \$10 billion. While those large banks accounted for 41 percent of the losses to the DIF, the remainder of DIF losses (\$48.48 billion) was due to failures by banks with assets of less than \$10 billion. Opportunities may exist for the FDIC to continue to refine the deposit insurance system to assess premiums more commensurate with risk-taking for smaller institutions. The asset- and funding-related stress measurements (e.g., asset concentration risk, balance sheet liquidity risk, etc.) that the FDIC implemented for large banks were relevant issues in many of the small- and mid-size bank failures during the past few years.

Advantages of the further refinement of the deposit insurance system for smaller institutions are that insurance premiums would (1) establish a better risk-based assessment approach that captures risk at the time that small banks assume the risk, (2) better price deposit insurance for risk among small institutions, and (3) take a more forward-looking view of risk. This option may also be more acceptable to the banking industry than placing

absolute limits on bank activities. However, it is important to note that the assessment system already considers the CAMELS component ratings, thus there is already some consideration of additional measurements related to asset quality, management, liquidity, etc. In addition, because insurance premiums are assessed a quarter in arrears, the FDIC may not receive premium payments for troubled or failing institutions.

### **Recommendation**

To improve the effectiveness of the PRA framework and to meet the section 38 and 39 goals of identifying problems early and minimizing losses to the DIF, we recommend that the FDIC, FRB, and OCC agency heads review the matters for consideration presented in this report and work through the Financial Stability Oversight Council to determine whether the PRA legislation or implementing regulations should be modified. As a recap, the matters for consideration are (1) develop specific criteria and corresponding enforcement actions for non-capital factors, (2) increase the minimum PCA capital levels, and (3) continue to refine the deposit insurance system for banks with assets under \$10 billion to assess greater premiums commensurate with risk-taking.

### **Agency Comments and OIG Evaluation**

We provided a draft of this report to the FRB, FDIC, and OCC for review and comment. The agencies provided technical comments, which we incorporated into the final report, where appropriate. The agencies also provided written comments that we have included in their entirety at appendix 5.

#### FRB's Response

The FRB stated that staff has initiated a process to develop criteria and corresponding enforcement actions for non-capital factors. Specifically, the response stated that FRB staff has developed an examination issues tracking process to enhance the monitoring of supervisory findings for each affected institution in response to FRB OIG MLR conclusions that there were opportunities for the FRB to take earlier and more forceful supervisory actions to address safety and soundness examination findings. FRB believes effective implementation of this process will minimize uncorrected safety and soundness weaknesses, which should lead to more

timely supervisory attention and accelerated enforcement actions to address supervisory concerns.

The FRB will continue to consider increasing the minimum PCA capital levels as part of the interagency work underway to review and improve capital standards based on Dodd-Frank requirements and the implementation of the Basel III capital accord in the United States. The FRB deferred to the FDIC regarding matters raised in our report related to refining the deposit insurance system for banks with assets under \$10 billion.

#### OIG Comment

The FRB's response and planned actions address the intent of our recommendation.

#### FDIC Response

The FDIC acknowledged that early warning factors identified in our report could be indicators of inappropriate risk-taking and agreed that the agencies should undertake a comprehensive review of these and other factors, along with corresponding supervisory actions, that could augment the existing PRA framework. The FDIC responded that both the agencies and the industry stand to benefit from the transparency and improved risk management that appropriate non-capital standards and supervisory responses could provide.

With respect to the second matter to be considered, the FDIC noted that the consensus of lessons-learned studies undertaken after the recent financial crisis is that capital requirements should be strengthened. The FDIC agreed to consider possibly modifying the PCA capital tripwires in the context of reviewing comments on an upcoming Notice of Proposed Rulemaking for the domestic implementation of the Basel III standards.

The FDIC also agreed that refining the deposit insurance system for banks with assets under \$10 billion could improve the alignment of premiums and risk taking and noted that staff is currently analyzing the initial performance of the new large bank pricing method. When this analysis is complete, staff will draw upon it to determine whether features of the large bank pricing methodology or other changes may improve the pricing method for small banks. The FDIC responded that by September 1, 2012, the

FDIC Division of Insurance and Research staff will provide to the Chairman an analysis, with recommendations where appropriate, of refinements to the deposit insurance pricing method for banks with assets under \$10 billion.

#### OIG Comment

The FDIC's planned actions address the intent of our recommendation.

#### OCC Response

With regard to developing specific criteria and corresponding enforcement actions for non-capital factors, the OCC stated that it has implemented, or is in process of implementing, numerous changes to its supervisory processes in response to the lessons learned from the recent severe recession. The OCC stated that hard wired PCA requirements that incorporate all the analysis that goes into its supervisory judgments would be extremely hard to implement without unintended consequences. The OCC also stated it already has enough supervisory tools to intervene at crucial stages of an institution's financial stress and that it did not think legislative changes to PCA were needed and expects that increases in the minimum PCA capital levels will be an outcome of the rulemakings that implement the Basel capital accord requirements. The OCC also deferred to the FDIC regarding matters raised in our report related to refining the deposit insurance system for banks with assets under \$10 billion.

#### OIG Comment

The OCC's response addressed the intent of our recommendation in that the OCC reviewed, deliberated, and responded to each of the matters for consideration. We encourage the OCC to work with the FRB and the FDIC in considering whether specific criteria and corresponding enforcement actions for non-capital factors can be developed. We believe that, by working together, the agencies can develop a framework to enhance the examiner's ability to address problems before significant losses occur, create a set of expectations among bank regulators concerning any enforcement actions that follow, and mitigate any unintended consequences.

Further, we note that in response to GAO's June 23, 2011, PCA report,<sup>39</sup> the OCC agreed to consider (1) additional triggers that would require early and forceful regulatory actions tied to specific unsafe banking practices and (2) incorporating an institution's risk profile into the PCA capital category thresholds. We believe that the actions that the OCC takes to address GAO's recommendations will also be responsive to our recommendation.

Finally, we want to clarify that our report did not recommend "hard wired PCA requirements" or "legislative changes to PCA." Rather, we recommended that the regulators consider establishing non-capital factors outside of the PCA framework. Such factors may or may not be quantitative and could range in specificity from a modest expansion of the implementing criteria for the existing safety and soundness standards to firm thresholds or limits, such as specific asset growth or concentration limits. Careful consideration by all three regulators will be necessary in order to develop effective, acceptable non-capital factors that provide a leading indication of risk.

\* \* \*

We would like to extend our appreciation to the FRB, OTS, FDIC, and OCC for the cooperation extended to our staffs during the evaluation. Major contributors to this report are listed in Appendix 6.

/s/  
Jon T. Rymer  
Inspector General  
Federal Deposit Insurance  
Corporation

/s/  
Eric M. Thorson  
Inspector General  
Department of the  
Treasury

/s/  
Mark Bialek  
Inspector General  
Board of Governors of the  
Federal Reserve System

---

<sup>39</sup> *Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness*, GAO-11-612, dated June 23, 2011.

## Objectives

Our objectives were to: (1) determine the purpose of and circumstances that led to the enactment of the PRA provisions and lessons learned from the banking and thrift crisis in the 1980s and early 1990s; (2) evaluate to what extent PRA provisions were a factor in bank failures and problem institutions during the current crisis (i.e., 2007 through the present); (3) assess whether PRA provisions prompted federal banking regulators to act more quickly and more forcefully to limit losses to the DIF in the current crisis in light of lessons learned from the 1980s and early 1990s; and (4) determine whether there are other non-capital measures that provide a leading indication of risks to the DIF that should be considered as part of PRA.

## Scope and Methodology

We conducted this evaluation from May 2010 through May 2011 in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* and performed the following procedures:

To determine the purpose of and circumstances that led to the enactment of the PRA provisions and lessons learned from the banking and thrift crisis in the 1980s and early 1990s, we:

- reviewed the PRA provisions and developed a legislative history;
- gained an understanding of problems encountered and lessons learned from the 1980s and 1990s crisis by reviewing: the Department of the Treasury's February 1991 report to Congress, *Modernizing the Financial System, Recommendations for Safer, More Competitive Banks; History of the Eighties – Lessons for the Future; Deposit Insurance: A Strategy for Reform* (GAO/GGD-91-26); and *Bank Supervision: Prompt and Forceful Regulatory Actions Needed* (GAO/GGD-91-69); and
- reviewed and summarized relevant issues from prior reviews of PRA effectiveness.

To evaluate to what extent PRA provisions were a factor in bank failures and problem institutions during the current crisis, we:

- reviewed agency supervision policies and procedures concerning the use of sections 38 and 39;
- conducted interviews with supervision and legal staff regarding the extent to which agencies use PRA provisions, the barriers to using sections 38 or 39 enforcement actions, and the extent agencies use other enforcement actions to address capital and non-capital issues. We also solicited views regarding PRA effectiveness, the appropriateness of current capital levels for section 38, and the potential impact of Basel III;
- determined and reviewed the population of all problem and undercapitalized banks for the scope period (January 1, 2006 through March 31, 2010). With the assistance of the FDIC's Division of Insurance and Research (DIR), we selected a statistically valid random sample of PCA and problem banks with a 90-percent confidence interval and a 3-percent margin of error. We analyzed the banks affected by PCA according to their status as failed, problem, or neither. We compiled data about sample items related to supervisory history, problem bank status, PCA levels, and associated enforcement actions;
- evaluated the timeliness of PCA by determining the length of time between banks reaching undercapitalized status and failure and by determining the capital level at which the banks failed. We tracked elapsed day information for when problems were first identified, when CAMELS ratings declined, when PCA levels declined, and when the FDIC pursued enforcement actions;
- assessed the function of PCA as an early identifier of problems by determining whether problem and PCA banks appeared on the problem bank list or undercapitalized level first. We used the random sample selected above to determine the reasons banks were on the problem list or reasons for failure for failed PCA banks. We compared capital triggers to other factors;

- evaluated the correlation between problem banks and PCA by analyzing problem bank and PCA status by quarter;
- determined the correlation between the Capital CAMELS component rating and PCA status by quarter;
- obtained and reviewed (for sample items) quarterly PCA regional reports; and
- reviewed the enforcement actions used by regulators for PCA and problem banks and identified enforcement trends.

To assess whether PRA provisions prompted federal regulators to act more quickly and more forcefully to limit losses to the DIF in the current crisis based on lessons learned from the 1980s and early 1990s, we:

- worked with FDIC DIR staff to identify and obtain historical data and statistics from the 1980s and 1990s crisis pertaining to information such as enforcement actions, capital levels, bank failures, and loss rates;
- compared historical data and statistics from the 1980s and 1990s crisis pertaining to information such as enforcement actions, capital levels, bank failures, and loss rates against data for the current crisis; and
- analyzed the cost of failed banks during the current crisis as compared to the 1980s and 1990s crisis as a percentage of assets.

To determine whether there are other non-capital measures that provide a leading indication of risks to the insurance fund that should be considered as part of PRA, we:

- identified other non-capital factors that could serve as a better early warning mechanism than PCA based on reviews of MLR reports and interviews with FDIC, OCC, OTS, and FRB officials;

- reviewed agency rules and regulations associated with PCA and the Safety and Soundness Standards;
- interviewed agency officials regarding their understanding of the history and purpose of PRA provisions; and
- reviewed applicable agency rulemakings to implement Dodd-Frank Act provisions and to strengthen the deposit insurance assessment system.

This appendix contains selected data for each of the four primary federal regulators.

There were 489 banks affected by PCA from January 1, 2006 through March 31, 2010. Table 8 provides information about PCA banks by regulator and by bank status as of December 31, 2010.

**Table 8: PCA Banks by Primary Federal Regulator (PFR)**

PFR	Failed	Problem Bank	Neither Problem Nor Failed	Agency Total
FDIC	178	109	27	314
FRB	32	11	6	49
OCC	44	19	10	73
OTS	37	13	3	53
<b>Totals</b>	<b>291</b>	<b>152</b>	<b>46</b>	<b>489</b>

Source: OIG analysis of FDIC data.

We reviewed 120 MLR reports to determine the sequence of events in bank failures. Table 9 provides a breakout by regulator of the Figure 4 timeline in the main body of the report.

**Table 9: Failed Bank Timeline by Regulator**

PFR	Problem Identified <sup>a</sup>	Informal Enforcement Action	Rated 4 or 5 <sup>b</sup>	Formal Enforcement Action	Undercapitalized <sup>c</sup>
	<b>Median Number of Days Before Failure</b>				
<b>FDIC</b>	886	402	269	104	115
<b>FRB</b>	1,211	992	340	280	106
<b>OCC</b>	1,060	264	261	232	82
<b>OTS</b>	2,159	308	274	244	100

Source: OIG analysis of Material Loss Reviews

<sup>a</sup>Examiners initially identified the problem that ultimately led to the bank's failure.

<sup>b</sup>Bank is assigned a composite CAMELS rating of "4" or "5" for the first time.

<sup>c</sup>Bank is first undercapitalized, significantly undercapitalized, or critically undercapitalized.

Table 10 shows loss rate information by regulator as of May 17, 2011.

**Table 10: Loss Rate Information by Regulator**

<b>PFR</b>	<b>Number of Failed Banks 2006-2010</b>	<b>Loss Estimates (in billions)</b>	<b>Loss Percentage</b>
FDIC	194	\$38.9	31.00%
FRB	34	\$5.8	28.86%
OCC	53	\$9.5	22.26%
OTS*	43	\$28.2	27.45%
<b>Total*</b>	<b>324</b>	<b>\$82.4</b>	<b>28.80%</b>

Source: OIG analysis of DIF estimated losses.

\*Washington Mutual Bank was excluded because Washington Mutual Bank had significant assets at failure and did not result in a loss to the DIF. Including Washington Mutual Bank would result in a 6.82 percent loss for OTS and a 13.28 total loss percentage.

Regulators' implementation of PRA provisions has been assessed previously by our offices and GAO in four separate studies. In general, all the prior studies noted that the regulators effectively used section 38 provisions when an institution became undercapitalized and found there was little use of the section 39 provisions to correct problems before capital deterioration.

**GAO Report - *Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions*** (GAO/GGD-97-18). In this November 1996 report, GAO assessed regulators' progress in implementing FDICIA's PRA provisions, as amended, and the impact of sections 38 and 39 of the FDI Act on federal oversight of the banking industry. GAO reported that the effectiveness of sections 38 and 39 could not be determined at the time because only a few institutions had been subject to enforcement actions under section 38 and, as of September 1996, regulators had not used their section 39 enforcement authority. Although GAO reported that section 38 gave depository institutions a strong incentive to increase capital levels to avoid mandatory restrictions and supervisory actions associated with being undercapitalized, GAO emphasized that the capital-based safeguards are inherently limited because capital does not typically show a decline until an institution has experienced substantial deterioration in other components of its operations and finances. Consequently, by the time seriously troubled institutions become subject to section 38's mandatory restrictions and enforcement actions, there may be few options available to prevent or minimize losses to the DIF.

Further, GAO stated that section 39, as amended, does not appear to significantly change the wide discretion that regulators have regarding the timing and severity of enforcement actions taken against troubled institutions. Section 39 was intended to increase the likelihood that regulators would take action to address safety-and-soundness problems before they result in the deterioration of capital. However, the guidelines and regulations issued by the regulators to implement section 39 do not (1) establish clear, objective criteria for what would be considered to be unsafe and unsound practices or conditions or (2) link the identification of such conditions to specific mandatory enforcement actions.

**FDIC OIG Report – *The Effectiveness of Prompt Corrective Action Provisions in Preventing or Reducing Losses to the Deposit Insurance Funds*** (Audit Report No. 02-013). The objective of this 2002 report was to determine the effectiveness of PCA provisions in preventing or reducing losses to the insurance funds at the time and specifically focused on determining whether section 38 actions were implemented in a timely manner for three failed institutions. Those three institutions accounted for about \$1.17 billion in losses or approximately 80 percent of the \$1.46 billion in total losses to the insurance funds from January 1997 to September 2001. The three institutions had a similar business strategy, which was to originate subprime loans, securitize those loans, and retain residual assets<sup>40</sup> generated through the securitization process.

This report stated that regulatory agencies rely on data prepared and submitted by institutions and that data may not always be reliable. In this case, the report concluded that section 38 provisions were not effective because prompt corrective actions could not be implemented timely primarily because the institutions valued the residual assets in a manner that increased income and inflated their reported capital balances above minimum capital levels that require regulators to invoke action.<sup>41</sup> The report also noted that section 38(g) lacked specific criteria for non-capital measures and recommended further study of that issue.

**FDIC OIG Report - *The Role of Prompt Corrective Action as Part of the Enforcement Process*** (Audit Report No. 03-038). The objective of this 2003 audit was to determine whether PCA provisions were used as part of the FDIC's enforcement process and served to reduce the losses to the DIF. The report found that PCA directives were part of the FDIC's supervisory process and prevented or reduced losses to the DIF. The report noted that the non-capital section 38(g) provisions were seldom used.

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<sup>40</sup> Residual assets are valued using three assumptions: default rates, prepayment rates, and discount rates. Optimistic assumptions in any one of those rates will increase the value of the residuals.

<sup>41</sup> The report noted that the federal banking regulators issued a final rule that limits the concentration of residual assets and establishes requirements for total risk-based capital in relationship to residual assets.

The report also outlined a number of factors that impacted the effectiveness of section 38 capital-related provisions, including the fact that the foundation of section 38 is capital, which can be a lagging indicator of an institution's operational and financial problems. In addition, the report discussed the fact that the implementation of PCA depends on the accuracy of capital ratios reported in Call Reports,<sup>42</sup> which may not always be accurate.

**GAO Report – Deposit Insurance – Assessment of Regulators' Use of Prompt Corrective Action Provisions and FDIC's New Deposit Insurance System (GAO-07-242).** This report was required by the Federal Deposit Insurance Reform Conforming Amendments Act of 2005.<sup>43</sup> GAO again emphasized that although regulators generally used PCA appropriately, capital is a lagging indicator and thus not necessarily a timely predictor of problems at banks and thrifts. In most cases GAO reviewed, regulators responded to safety and soundness problems in advance of a bank or thrift's decline in required PCA capital levels.

With respect to non-capital related supervisory actions regulators can take under section 38 and 39, GAO found that regulators generally made limited use of those authorities, in part because they chose other informal or formal actions to address problems at troubled institutions. The report states that according to regulators, other tools, such as cease and desist orders, may provide more flexibility than those available under sections 38 and 39 because they are not tied to an institution's capital level and may allow them to address more complex or multiple deficiencies with one action.

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<sup>42</sup> See Glossary in Appendix 4 for a definition of Call Report.

<sup>43</sup> Pub. L. No. 109-173.

Call Report

Every national bank, state member bank, and insured nonmember bank is required by the Federal Financial Institutions Examination Council to file consolidated Reports of Condition and Income (Call Report) as of the close of business on the last day of each calendar quarter.

CAMELS

An acronym for the performance rating components: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Numerical values range from 1 to 5, with 1 being the highest rating and 5 representing the worst-rated banks.

Concentration

A group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of the institution's core capital plus allowance for loan and lease losses. Concentrations may include direct, indirect, and contingent obligations or large purchases of loans from a single counterparty. Some higher-risk asset or liability types (e.g., residual assets) may warrant monitoring as concentrations even if they do not exceed 25 percent of core capital plus an allowance for loan lease losses.

Deposit Insurance Fund

The DIF was created in 2006, when the Federal Deposit Insurance Reform Act of 2005 provided for the merging of the Bank Insurance Fund and the Savings Association Insurance Fund. The FDIC administers the DIF, the goal of which is to (1) insure the deposits and protect the depositors of DIF-insured institutions and (2) upon appointment of the FDIC as receiver, resolve failed DIF-insured institutions at the least possible cost to the DIF (unless a systemic risk determination is made). The DIF is primarily funded from deposit insurance assessments.

Leverage Capital Ratio

Defined in 12 C.F.R. §325(m) as the ratio of Tier 1 capital to total assets. Total assets means the average of total assets required to be included in a

banking institution's Call Report or, for savings associations, the consolidated total assets required to be included in the Thrift Financial Report. Because these reports may from time to time be revised, the calculation should use total assets as of the most recent report date (and after making any necessary subsidiary adjustments for state nonmember banks as described in §325.5(c) and 325.5(d) of this part), minus

- intangible assets (other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital pursuant to §325.5(f)),
- credit-enhancing interest-only strips that are not eligible for inclusion in core capital pursuant to §325.5(f),
- deferred tax assets in excess of the limit set forth in §325.5(g),
- assets classified loss and any other assets that are deducted in determining Tier 1 capital, and
- the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from Tier 1 capital as set forth in section II.B.(6) of appendix A to this part.

#### Material Loss Review

A material loss review reports on the causes of bank failure and the primary federal banking regulator's supervision of that institution. Before July 21, 2010, a material loss was defined as a loss to the DIF that was in excess of the greater of \$25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver. Amended by the Dodd-Frank Act, effective July 21, 2010, section 38(k) defines a loss as material if it exceeds \$200 million for calendar years 2010 and 2011, \$150 million for calendar years 2012 and 2013, and \$50 million for calendar years 2014 and thereafter (with a provision that the threshold can be raised temporarily to \$75 million if certain conditions are met).

Problem Bank

Problem banks are institutions included on the Problem Financial Institution List, commonly referred to as the Problem Bank List, which is developed by the FDIC and consists of financial institutions that are rated CAMELS composite 4, meaning the institution exhibited unsafe or unsound practices or conditions, or composite 5, meaning the institution exhibited extremely unsafe and unsound practices or conditions.

Prompt Corrective Action

A framework of supervisory actions, set forth in 12 U.S.C. §1831o, for insured depository institutions that are not adequately capitalized. It was intended to resolve the problems of the insured depository institutions at the least possible long-term loss to the DIF. The capital categories are well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.

Thrift Financial Report

A financial report that thrifts are required to file quarterly. The report includes detailed information about the institution's operations and financial condition, and must be prepared in accordance with generally accepted accounting principles. The thrift financial report for thrifts is similar to the Call Report required of commercial banks.

Tier 1 Risk-Based Capital Ratio Tier 1 capital is defined, as

**The sum of:**

- Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values);
- Non-cumulative perpetual preferred stock; and
- Minority interest in consolidated subsidiaries;

**Minus:**

- identified losses;
- certain intangible assets;
- investment in securities subsidiaries subject to section 537.4; and
- deferred tax assets in excess of the limit set in section 325.5(g).

Total Risk-Based Capital Ratio Defined under 12 C.F.R. §325(y) as the ratio of qualifying total capital to risk-weighted assets, as calculated in accordance with the FDIC's Statement of Policy on Risk-Based Capital (appendix A to subpart A of Part 325).



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

September 27, 2011

Mr. Mark Bialek  
Inspector General  
Federal Reserve Board of Governors  
Washington, DC 20551

Mr. Jon T. Rymer  
Inspector General  
Federal Deposit Insurance Corporation  
Arlington, VA 22226

Mr. Eric M. Thorson  
Inspector General  
Department of the Treasury  
Washington, DC 20220

Dear Sirs,

Thank you for the opportunity to review and comment on the joint Offices of Inspector General (OIGs) draft August 2011 report entitled "Evaluation of Prompt Regulatory Action Implementation." The Federal Reserve Board (FRB) concurs with the general findings of the report.

In the draft report, the OIGs recommend that the heads of the federal banking regulatory agencies consider taking various actions to strengthen Sections 38 and 39 (together, prompt regulatory action, or PRA) of the Federal Deposit Insurance Act. Specifically, the OIGs recommend that the banking agencies consider the following options to strengthen, or indirectly support, the PRA provisions: (1) develop specific criteria and corresponding enforcement actions for non-capital factors, (2) increase the minimum prompt corrective action (PCA) capital levels, and (3) continue to refine the deposit insurance system to assess greater premiums commensurate with risk taking.

As your report notes, the FRB is among the agencies that have not explicitly used Section 39, which was designed to address deficiencies related to an institution's operations and

activities other than inadequate capital. Instead, the FRB addresses non-capital deficiencies using other supervisory tools, such as informal and formal enforcement actions. The FRB still considers these supervisory tools as effective for addressing significant safety-and-soundness concerns.

FRB staff has initiated a process that addresses the OIGs' recommendation to develop criteria and corresponding enforcement actions for non-capital factors. In response to conclusions noted in the FRB OIG's Material Loss Reviews on a number of banks that failed from 2008 through 2011 that there were opportunities for the FRB to take earlier and more forceful supervisory actions to address safety-and-soundness examination findings, FRB staff has developed an examination issues tracking process to enhance the monitoring of supervisory findings for each affected institution. Depending on the degree of concerns and responsiveness of bank management, institutions with uncorrected deficiencies or repeat deficiencies may be subject to increasingly strong supervisory actions, both informal and formal, until deficiencies are corrected. FRB staff believes effective implementation of this process will minimize uncorrected safety-and-soundness weaknesses, which should lead to more timely supervisory attention and accelerated enforcement actions to address supervisory concerns.

With regard to capital deficiencies, the report acknowledges that the FRB, as well as other agencies, implemented requirements of PCA effectively. Overall, the FRB continues to view PCA as a useful supervisory tool for ensuring that nonviable banks are resolved within prompt timelines, which contributes to a sound financial system. The FRB, however, recognizes the limitations of the PCA framework. Although it is early in the process, interagency work is underway to review and improve capital standards based on requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the U.S. implementation of the Basel III capital accord. As this work progresses, subject to practical limitations, the FRB will continue to consider the recommendation noted in the OIGs' report to increase the minimum PCA capital levels.

With regards to the third recommendation for consideration, the FRB will defer to the Federal Deposit Insurance Corporation (FDIC) on changes in deposit insurance premiums. The FRB will submit views if solicited by the FDIC.

Thank you for the opportunity to respond to the OIG report.

Sincerely,

/s/

Maryann F. Hunter  
Deputy Director



**Federal Deposit Insurance Corporation**  
550 17th Street NW, Washington, D.C. 20429-9990

Office of the Chairman

26 September 2011

Jon T. Rymer  
Inspector General  
Federal Deposit Insurance Corporation  
3501 Fairfax Drive, Arlington, VA  
Arlington, VA 22226

Eric M. Thorson  
Inspector General  
U.S. Department of the Treasury  
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Washington, DC 20220

Mark Bialek  
Inspector General  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> and C Streets, NW, Mail Stop 300  
Washington DC 20551

**Re: Response to Draft Report Entitled *Evaluation of Prompt Regulatory Action Implementation (2010-054)***

Dear Gentlemen:

The FDIC has received and considered the recommendations in the draft *Evaluation of Prompt Regulatory Action Implementation* (Draft Report) conducted jointly by the Inspectors General of the Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System, and the U.S. Department of the Treasury. The Draft Report finds that the Prompt Corrective Action (PCA) framework has been effective in limiting troubled institutions' access to high-risk funding, restricting asset growth, prohibiting dividends, and assuring the prompt closure of critically undercapitalized institutions. However, PCA has proven to be ineffective as an early warning indicator of risk in financial institutions. The Draft Report also finds that the federal banking agencies (agencies) appropriately implemented PCA pursuant to Section 38 of the Federal Deposit Insurance Act (FDI Act) and, in most cases, used other enforcement actions to address safety-and-soundness concerns before PCA thresholds were triggered.

The Draft Report offers three recommendations to effectively address safety-and-soundness concerns to avoid, or at least lessen, significant financial losses from a future crisis: 1) develop specific criteria and corresponding enforcement actions for non-capital factors; 2) increase the minimum PCA capital levels; and 3) continue to refine the deposit insurance system for banks with assets under \$10 billion to assess greater premiums commensurate with risk taking.

The Draft Report recommends the agencies develop specific criteria and corresponding enforcement actions for non-capital factors to be incorporated into the Prompt Regulatory Action (PRA) framework and lists several potential non-capital factors to be considered, including asset growth, concentrations in commercial real estate or mortgage loans, non-core funding, and

non-performing loans. The Inspectors General have documented these particular factors as early warning indicators in numerous material loss reviews of failed institutions. We acknowledge that these factors can be indicators of inappropriate risk-taking, and we agree that the agencies should undertake a comprehensive review of these and other factors, along with corresponding supervisory actions, that could augment the existing PRA framework. Both the agencies and the industry stand to benefit from the transparency and improved risk management that appropriate non-capital standards and supervisory responses could provide.

With respect to the second recommendation, the consensus of lessons-learned studies undertaken after the recent financial crisis is that capital requirements should be strengthened. The FDIC anticipates the agencies will seek comment later this year on a Notice of Proposed Rulemaking for the domestic implementation of the Basel III standards recently published by the Basel Committee on Banking Supervision. In conjunction with that proposal the agencies expect to consider modifications to the PCA capital triggers as well as other potential changes designed to strengthen the PCA framework. Accordingly, the FDIC and other agencies will consider jointly the Inspectors General's recommendation of possible modifications to the capital tripwires in the context of the comments received on that rulemaking.

The FDIC agrees that refining the deposit insurance system for banks with assets under \$10 billion could improve the alignment of premiums and risk taking. Staff is currently analyzing the initial performance of the new large bank pricing method (which became effective beginning April 1, 2011). When this analysis is complete, staff will draw upon it to determine whether features of the large bank pricing methodology or other changes may improve the pricing method for small banks. By September 1, 2012, DIR staff will provide to the Chairman an analysis, with recommendations where appropriate, of refinements to the deposit insurance pricing method for banks with assets under \$10 billion.

We appreciate the Draft Report's thoroughness and the auditors' efforts to put the role of the PRA statutes into historical context, as well as the assessment of their overall effectiveness in reducing losses to the FDIC's Deposit Insurance Fund during the current financial crisis. We believe PRA, as currently structured, has been a valuable addition to enforcement tools available to the federal banking agencies. Additionally, the FDIC has and continues to work to improve the accuracy and timeliness of its supervisory and enforcement processes in response to identified lessons learned, and we are pleased the Draft Report acknowledges this.

Thank you for the opportunity to review the Draft Report.

Sincerely,

Martin J. Gruenberg /S/  
Acting Chairman



## MEMORANDUM

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Comptroller of the Currency  
Administrator of National Banks

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Washington DC 20219

To: Jon T. Rymer, Inspector General, Federal Deposit Insurance Corporation  
Eric M. Thorson, Inspector General, Department of the Treasury  
Mark Bialek, Inspector General, Board of Governors of the Federal Reserve System

From: John Walsh, Acting Comptroller of the Currency /s/

Date: September 26, 2011

Subject: Comments on Draft Report on Prompt Regulatory Action

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We have received and reviewed your draft report titled "Evaluation of Prompt Regulatory Action Implementation." Your overall objectives were to determine the purpose and use of the prompt regulatory action (PRA) provisions established by the Federal Deposit Insurance Corporation Improvement Act of 1991 in the current financial crisis.

You concluded that regulators implemented prompt corrective action (PCA) appropriately; identified deficiencies prior to undercapitalization; used other enforcement actions to respond to safety and soundness concerns before undercapitalization, but after financial decline occurred; and made limited use of Section 39 to address deficiencies identified. You also concluded that inherent limitations with PCA's capital-based framework and the sudden and severe economic decline affected PCA's effectiveness and that critically undercapitalized institutions were closed promptly, but overall losses were significant. We agree.

To improve the effectiveness of the PRA framework and to meet the goals of identifying problems early and minimizing losses to the deposit insurance fund, you recommend that the federal bank regulators review matters offered for consideration and work through the Financial Stability Oversight Council to determine whether the PRA legislation or implementing regulations should be modified. You asked that we consider developing specific criteria and corresponding enforcement actions for non-capital factors, increasing the minimum PCA capital levels, and continuing to refine the deposit insurance system for banks with assets under \$10 billion to assess greater premiums commensurate with risk-taking.

As discussed in the August 30, 2011 exit meeting, the OCC has implemented, or is in process of implementing numerous changes to our supervision processes in response to the lessons learned from the recent severe recession. These actions include revising concentration and stress testing guidance, enhancing our risk assessment and CAMEL ratings assignment processes and updating our capital planning guidance, to name a few. We are also making greater use of other tools, such as Individual Minimum Capital Requirement orders, to intervene at an earlier stage, and

Appendix 5  
Regulators' Responses

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plan to continue to do so. In examiner communications, we are stressing the importance of identifying and taking actions to address undue risk taking by the institutions we regulate **before** these risks manifest as extreme threats to capital and the soundness of the institution.

However, we feel that hard wired PCA requirements that incorporate all of the analysis that goes into our supervisory judgments would be extremely hard to implement without unintended consequences. For example, rapid growth is certainly a red flag, but the source of the growth is important to the analysis. Natural growth in core deposits that fund well underwritten loans in a rapidly growing community is not the same as growth driven by out of area construction lending funded by brokered deposits or borrowings, even if the growth rates in the two institutions are the same. Likewise, concentrations that are an equal percentage of capital can pose vastly different threat levels depending on the volatility of the asset class and the exact composition of the concentration.

We feel that we already have enough supervisory tools to intervene at crucial stages of an institution's financial stress. And although the financial crisis demonstrated that there are circumstances where these tools could have been used to advantage in earlier stages of those situations, we do not think that legislative changes to PCA are needed. If PCA requirements are set too tight in response to the worst downturn since the Great Depression, we run the risk of closing financial institutions that could have remained viable.

We expect that increases in the minimum PCA capital levels will be an outcome of the rulemakings that implement the Basel capital accord requirements.

We defer to the FDIC on making improvements to the deposit insurance system.

Thank you for the opportunity to review and comment on your draft report. If you need additional information, please contact David K. Wilson, Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner at 202-874-4961.

**FDIC OIG Headquarters**

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Margaret B. Wolf, Senior Audit Specialist  
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E. Marshall Gentry, Assistant Inspector General for Evaluations

**Federal Reserve Board of Governors OIG**

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Acting Comptroller of the Currency

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