Chapter 8 – Comparison of Prompt Corrective Actions and Section 8 Actions

Comparison of Prompt Corrective Actions and Section 8 Actions

In some cases, the FDIC may pursue formal action under either Section 38 (PCA) or Section 8 of the FDI Act. Examples include the following:

- Appointing a receiver or conservator under Section 38 or terminating deposit insurance under Section 8(a).
- Issuing a supervisory directive under Section 38 or a cease-and-desist order under Section 8(b).
- Dismissing officials under Section 38, or removing them from office or from participation in the banking industry under Section 8(e).

Determining whether action should be initiated under Section 38 or Section 8 requires careful consideration of both sections of the FDI Act and related references, as well as the specific circumstances facing a particular institution. This chapter provides basic considerations in determining whether action should be based on Section 38 or Section 8, in cases where FDIC staff may pursue action under either authority.

Additional information on the use and processing of enforcement actions under these sections of the FDI Act may be found in chapters 4, 5, and 6, which specifically address these actions.

Appointment of Receiver or Conservator vs. Insurance Termination

Federal law and laws in most states prohibit financial institutions from operating without deposit insurance. For this reason, terminating insurance under Section 8(a) of the FDI Act may result in an IDI's closure and the subsequent appointment of a receiver. Appointment of a receiver/conservator also may be achieved through PCA proceedings under Section 38.

Considerations for determining which section should be used to appoint a receiver/conservator follow.

PCA Requirements

Section 38 states that the appropriate federal financial regulatory agency shall take one of the following actions no later than 90 days after an institution becomes critically undercapitalized.

- Appoint a receiver or conservator.
- Take other action (with FDIC concurrence) that the agency determines will better achieve the purpose of PCA.

However, under certain circumstances, the 90-day period may be extended if it is in the interest of the DIF. (Refer to Delaying Mandatory Resolution in Chapter 5 – Prompt Corrective Action for a list of these circumstances.)

Note: An institution is deemed critically undercapitalized if its ratio of tangible equity capital to total assets is two percent or less. Tangible equity capital includes cumulative perpetual preferred stock and related surplus, which is not included in the calculation of the leverage ratio. Section 324.4(c) states that an institution with a ratio of tier 1 capital to total assets that is less than less than two percent is deemed to be in an unsafe or unsound condition.

Section 8(a) Requirements

Section 8(a) provides three possible grounds for terminating an institution's insured status:

- The institution's officers or directors have engaged in unsafe or unsound practices.
- The institution's officers or directors have violated a law, regulation, order, condition imposed in writing by the FDIC, or written agreement with the FDIC.
- The institution is in an unsafe or unsound condition.

Required Hearings

No formal Administrative Procedure Act hearing is required before appointing a receiver or conservator under Section 38. In contrast, Section 8(a)(2) states that the FDIC may terminate an institution's insured status only after providing the institution with notice of the action and granting the opportunity for a hearing.

Results of PCA and Section 8(a) Action

Both Section 38 and Section 8(a) actions may have the effect of closing institutions that pose a substantial risk to the DIF. A successful Section 8(a) proceeding terminates an institution's insured status. The termination of insured status generally results in the closing of the institution by its chartering authority and the subsequent appointment of a receiver. Section 38 authorizes the automatic appointment of a receiver or conservator for critically undercapitalized institutions.

Selecting the Appropriate Remedy

The choice of whether to use Section 38 or Section 8(a) as a remedy depends on the condition of the institution.

Critically undercapitalized institutions – Section 38 action appears to be appropriate for critically undercapitalized institutions. Due to the delay caused by the need for a formal hearing under Section 8(a), the automatic appointment of a receiver authorized by PCA may achieve the FDIC's purposes in a timelier manner.

Note: the FDIC—if it is the appropriate FBA—must appoint a receiver beginning 270 days after the date on which the IDI became critically undercapitalized, unless the FDIC can document reasons why not appointing a receiver would better serve the purposes of PCA.

Institutions in an unsafe or unsound condition but not critically undercapitalized – Regardless of capital levels, an institution may be in an unsafe or unsound condition. Such an institution may not be subject to the automatic appointment of a receiver under PCA; however, it may be subject to termination of insurance under Section 8(a).

If an institution is less than adequately capitalized, both PCA and Section 8(a) provide the regulatory flexibility needed to protect the DIF as follows:

- For institutions in an unsafe or unsound condition that are not critically undercapitalized, a PCA directive would require that an institution take immediate corrective measures.

- For institutions that remain in an unsafe or unsound condition—despite corrective measures being implemented—but do not become critically undercapitalized, action could be instituted under Section 8(a) to terminate an institution's insurance since Section 8(a) does not tie the FDIC's authority to a certain capital percentage.

<u>Institutions requiring high capital percentages for safety and soundness reasons</u> – To remain in a safe and sound condition, certain institutions may require a capital level that is far higher than the institution needs to be deemed adequately capitalized or well capitalized for PCA purposes.

The FDIC may consider terminating deposit insurance under Section 8(a) for institutions that have engaged in unsafe or unsound practices or violated a law, order, or written agreement, but have high levels of capital and yet are a significant risk to the DIF. Appointment of a receiver under Section 11 may also be warranted in these circumstances.

Note: Section 11 allows the FDIC to appoint itself receiver for reasons not directly related to an institution's capital status; those reasons include, but are not limited to, substantial dissipation of the institution's assets or earnings, the institution's inability to pay its obligations or meet the demands of its depositors, and the willful violation of a cease-and-desist or consent order.

<u>Institutions engaging in unsafe or unsound practices, or violations</u> – The FDIC could consider a Section 8(a) action against institutions that engage in unsafe or unsound practices or violate a law, regulation, written condition imposed by the FDIC, or written agreement with the FDIC. However, other remedies are generally considered and/or attempted prior to initiating such action.

PCA Directives vs. Cease-and-Desist Orders

The FDIC has the option of issuing supervisory directives and/or cease-and-desist or consent orders to institutions in any of the following capital categories:

- Undercapitalized,

- Significantly undercapitalized, or

- Critically undercapitalized.

PCA Requirements

The FDIC may issue supervisory directives requiring corrective action or compliance with the requirements of Section 38 to institutions that are undercapitalized, significantly undercapitalized, or critically undercapitalized. Each capital category carries certain mandatory restrictions, which are automatically imposed upon the institution.

For undercapitalized institutions, PCA directives may include discretionary provisions that are additional actions or restrictions the FDIC could impose if necessary for PCA purposes. However, for institutions that are significantly undercapitalized or undercapitalized without an acceptable capital restoration plan, Section 38 requires that the FBA impose one or more of the applicable discretionary provisions.

Issuance of a supervisory directive is not required if the FDIC determines that only the applicable mandatory provisions of PCA must be imposed. The mandatory provisions become effective immediately by operation of law. However, imposing discretionary provisions onto an institution requires that the FDIC issue a supervisory directive.

Section 8(b) Requirements

Under Section 8(b) of the FDI Act, the FDIC may issue cease-and-desist or consent orders to institutions or IAPs that have engaged or are about to engage in either of the following actions:

- An unsafe or unsound practice in conducting the business of the institution.
- A violation of a law, rule, regulation, written agreement, or condition imposed in writing in connection with the granting of any application or other request by the institution.

Cease-and-desist or consent orders may include provisions requiring an institution or IAP to halt violations or practices, or to take affirmative action to correct any conditions resulting from such violations or practices.

Required Hearings

If an institution is not willing to stipulate to a Section 8(b) action, the FDIC may issue a NOC that may be contested through a hearing before an administrative law judge. However, except as provided below, a hearing is not usually required when the FDIC issues a PCA directive. The FDIC must, however, provide an institution with NOI to issue a PCA directive. The institution has at least 14 days to file a written response to the directive, unless the FDIC determines that a shorter time period is appropriate, given the condition of the IDI or other relevant circumstances. The FDIC's determination, after considering a response, is considered final under Section 308.201 of the FDIC Rules and Regulations. An institution can submit a written request to modify or rescind the directive if the institution has had a change in circumstances that impacts its financial or operating condition.

A hearing is available prior to issuance of a PCA directive in only two situations:

- The institution's PCA capital category is being reclassified based on a less-than-satisfactory rating for asset quality, management, earnings, or liquidity in an ROE (and the deficiency is not corrected) as set forth in Section 308.202 of the FDIC Rules and Regulations, or
- The FDIC intends to dismiss a director or senior executive officer of the institution from office as set forth in Section 308.203 of the FDIC Rules and Regulations.

In either case, the required hearing is more limited than a Section 8(b) hearing.

Considerations in Using PCA Directives and Section 8(b) Actions

For IDIs that are well capitalized and adequately capitalized, the FDIC's cease-and-desist powers under Section 8(b) can be used to halt violations or unsafe or unsound practices, or to take affirmative action to correct any conditions resulting from such violations or practices. For institutions in the three undercapitalized categories, however, the FDIC has the option of issuing a PCA directive, a cease-and-desist order, or both. The following factors should be considered in determining whether to issue PCA directives and/or cease-and-desist orders in these instances.

PCA directives may impose more restrictions than Section 8(b) orders. The purpose of Section 38 of the FDI Act is to resolve the problems of IDIs at the least possible long-term loss to the DIF. Section 38 defines specific mandatory provisions that must be imposed upon an institution if it is deemed critically undercapitalized, significantly undercapitalized, or if it is an undercapitalized institution that has failed to submit an acceptable capital restoration plan or failed to implement an approved capital restoration plan. Additionally, Section 38(f)(2)(J) provides discretionary provisions that the FDIC may require an institution to take, including any other action that will better carry out the purpose of PCA than any of the actions specifically described in Section 38(f)(2).

In contrast, Section 8(b) actions are individually tailored to address supervisory concerns of specific institutions and require that the institution cease and desist from the identified practice or violation and take affirmative action to correct the condition resulting from such practice or violation. There are no specific restrictions contained in Section 8(b). Additionally, Section 8(b) actions (unlike Section 38 actions) do not require the FDIC to demonstrate that unsafe or unsound practices have not been corrected.

PCA-directive provisions may be included in a cease-and-desist order. The PCA restrictions applicable to institutions in the three undercapitalized categories can be included in the provisions of a cease-and-desist order. However, issuing a PCA directive would be faster and simpler if the institution plans to contest the Section 8(b) action because in most cases, a PCA directive does not require a hearing.

PCA directives may not apply after an institution becomes adequately capitalized. Generally, the provisions of a PCA directive no longer apply after an institution has been adequately capitalized for four consecutive calendar quarters (although a termination order is required to formally end the action). However, the FDIC may want an institution to raise its capital to a level higher than that required for adequately capitalized institutions under PCA, or continue to abide by other provisions in the PCA Directive even after the institution reaches the higher capital level. In these instances, a Section 8(b) action would be appropriate.

PCA directive provisions usually do not address violations of laws, regulations, or written agreements or conditions. The provisions included in PCA directives generally do not address correction of violations of laws, rules, regulations, written agreements, or conditions imposed in writing in connection with the granting of any application or other request by an institution. Therefore, in these circumstances, a Section 8(b) action would be more appropriate than a PCA directive.

Selecting the Appropriate Remedy

For institutions in the three undercapitalized categories, the FDIC has three options:

- Issue a cease-and-desist or consent order, which may include PCA-directive provisions;
- Issue both a PCA directive and a cease-and-desist order; or
- Issue a PCA directive only.

If PCA provisions are to be included in a cease-and-desist order, FDIC staff should attempt to obtain the institution's consent to the order. As a matter of procedure, FDIC staff may send the following documents to the institution at the outset of the action: a proposed stipulation and consent to the issuance of an order to cease and desist, an order to cease and desist, and a proposed PCA directive. If the institution consents to the more-inclusive Section 8(b) action, the FDIC may not need to issue the PCA directive.

If an institution is unwilling or unlikely to consent to a Section 8(b) action, the FDIC can proceed with both actions. In most cases, the actions will have similar provisions. However, the PCA directive provisions will become effective in a timelier manner and will remain effective throughout the Section 8(b) hearing process. The Section 8(b) order may, however, contain additional provisions that outlast the limited scope of the PCA directive. Further, the Section 8(b) order will remain effective until formally terminated by the FDIC.

There may be circumstances in which the FDIC's concerns would be fully addressed by a PCA directive alone. For example, a PCA directive would be sufficient if all of the FDIC's concerns were related to an institution's capital, and those concerns would be alleviated once the institution became adequately capitalized.

Note: Section 38(g) offers an informal hearing-process for institutions that are reclassified based on a less-than-satisfactory rating for asset quality, management, earnings, or liquidity in an ROE. The hearing is generally more streamlined than hearings required for Section 8(b) proceedings.

Provisions of PCA Directives and Cease-and-Desist or Consent Orders

In deciding which provisions to include in a PCA directive, FDIC staff should first determine whether there is an existing Section 8(b) order against the institution. If so, a PCA directive (if issued) need only include those provisions not covered in a final cease-and-desist order.

If a Section 8(b) order does not exist, the FDIC should assess the institution's willingness to stipulate to an order. If the institution is willing to stipulate, the FDIC would attempt to incorporate all provisions in a Section 8(b) order. However, if the institution is unwilling or unlikely to consent to a Section 8(b) action, the FDIC may pursue issuance of a PCA directive and initiate cease-and-desist proceedings simultaneously. When both a PCA directive and a cease-and-desist order are issued, FDIC staff must carefully consider the provisions that are included in each document. Both documents should include provisions that require the institution to increase its capitalization. However, the capital requirements for each document differ. Under Section 38, an IDI need only meet or exceed the minimum capital levels prescribed by regulation in order to fall within a certain PCA category (well capitalized, adequately capitalized, etc.). In contrast, a Section 8(b) order, among other provisions, may require an IDI to obtain capital levels that exceed PCA thresholds because the institution's condition and inherent risks threaten its solvency.

The proposed Section 8(b) order may include all provisions included in the PCA directive as well as any additional requirements concerning capital or other unsafe or unsound practices or violations not covered by PCA.

PCA Directives vs. Temporary Cease-and-Desist Orders

PCA Directives and Section 8(c) actions allow the FDIC to act with the utmost speed when the facts so dictate; however, they are often triggered by different events. PCA directives are triggered by capital events, while Section 8(c) actions are most often triggered when violations or unsafe or unsound practices are likely to cause insolvency or substantial dissipation of the assets or earnings of an IDI. A Section 8(c) action is not typically pursued when an institution's capital is the FDIC's primary concern. For these reasons, it is unlikely that PCA directives will affect Section 8(c) actions.

Note: If PCA applies to an institution and if the provisions that would be included in a temporary cease-and-desist order are mandated by PCA, it is not necessary to initiate a Section 8(c) action. The institution is already subject to the PCA provisions by operation of law.

PCA Dismissals vs. Section 8(e) Removals

In certain circumstances, the FDIC has the option of dismissing directors or senior executive officers from an institution under PCA or removing and prohibiting them from office in accordance with Section 8(e).

PCA Requirements

Under Section 38(f)(2)(F)(ii), the FDIC can require an IDI to dismiss directors or senior executive officers if the institution is significantly undercapitalized and, in some circumstances, if the institution is undercapitalized and has failed to submit an acceptable capital restoration plan or fails to implement an approved capital restoration plan.

Section 8(e) Requirements

The FDIC must demonstrate three grounds to institute an action for removal and/or prohibition against any IAP under Section 8(e) of the FDI Act: misconduct, the effect of the misconduct, and the individual's culpability for the misconduct. For a detailed description of the grounds for removal or prohibition under Section 8(e), refer to Chapter 6 – Removal, Prohibition, and Suspension Actions.

Results of Dismissals and Removals

Directors or senior executive officers dismissed under Section 38 are prevented from serving in the same capacity at the institution from which they were dismissed. In contrast, an individual removed from office under Section 8(e) is prohibited from serving as an IAP at any IDI.

Stricter Standards for Removals

Standards for removal under Section 8(e) are stricter than those required for Section 38 dismissals, for two reasons:

- A Section 8(e) removal results in an industry-wide prohibition. A PCA dismissal prohibits a director or senior executive officer from employment in the same position at the institution subject to the directive, and the dismissal is tied to that institution's needs.

- Section 8(e) requires misconduct or malfeasance on the part of the IAP to be removed or prohibited. PCA dismissals do not require misconduct on the part of the individual. Instead, it is sufficient to demonstrate that an individual does not have the capacity to materially strengthen the institution's ability to become adequately capitalized and/or correct unsafe or unsound conditions or practices.

Relation of Dismissals and Removals

If an officer or director of an institution is unwilling to stipulate to a removal and prohibition action due to misconduct under Section 8(e) of the FDI Act, a decision to dismiss under PCA should be seriously considered if the institution is in an undercapitalized or worse capital category under Section 38. When an officer or director of an institution is unwilling to stipulate to a removal and prohibition action, the FDIC may issue an NOI to remove under Section 8(e). The timeframe to effect an individual's removal via a contested administrative proceeding may be protracted. In contrast, a dismissal effected through the issuance of the PCA directive could be implemented immediately.

An individual dismissed from an IDI under Section 38 does not hinder or prevent a subsequent Section 8(e) action to prohibit that individual from further participation in the banking industry.

Justification Required for Dismissals

Section 38 and FDIC regulations regarding Section 38 do not impose any restraints on the FDIC's discretion in making an initial determination to dismiss directors or officers from institutions that are significantly undercapitalized, or undercapitalized institutions that have failed to submit and implement an acceptable capital restoration plan. However, a director or officer dismissed under a Section 38 dismissal order may obtain an administrative review of that order by filing a written petition for reinstatement with the appropriate FBA. In such circumstances, the FDIC would have to show that the officer or director would not materially strengthen the institution's ability to increase capital or to correct unsafe or unsound practices or conditions as set forth in Section 308.203(e) of the FDIC Rules and Regulations.

Considerations in PCA Dismissals

An initial determination to dismiss a director or senior executive officer should be based on an evaluation of the individual's performance at his or her current or any prior institutions. Essentially, this is the same analysis required by Section 32 of the FDI Act and the Change in Bank Control Act (Section 7(j)).

Under Section 32, an IDI that is not in compliance with minimum capital requirements or that is considered to be in a troubled condition (as defined in 12 C.F.R. Section 303.101(c)) must provide the FDIC with advance notice of the addition of directors or the employment of any senior executive officers. FDIC regulations provide that, in assessing such notice, the FDIC will consider the *competence, experience, character,* and *integrity* of the individual. The FDIC will issue a disapproval of the notice if an assessment of these factors indicates the individual's association or employment with the institution would not be in the best interests of depositors or the public.

The FDIC considers the same factors when evaluating applications for ownership or control filed under Section 7(j). Section 7(j) also requires the FDIC to analyze the financial resources of the applicant.

In determining whether to recommend dismissal, FDIC staff should consider the factors specified in the FDIC regulations for Section 32 actions, as described above.

Employment at an Institution after Dismissal

Section 38(f)(2)(F)(ii) authorizes the FDIC to require an institution to dismiss directors and senior executive officers. Refer to the section *Dismissing Directors or Senior Executive Officers* in Chapter 5 – Prompt Corrective Action for additional information on this topic. Section 38(n)(3) provides that an individual who is subject to dismissal or who is requesting reinstatement must demonstrate that his or her continued employment will materially strengthen the institution in specific areas set forth in the statute. If such a request is made, the Legal Division should be consulted.

If the institution is seeking to have the dismissed individual serve as a senior executive officer but in a different capacity, the institution must notify the FDIC in accordance with Section 32. In these circumstances, the FDIC could disapprove a role deemed inappropriate based on the individual's experience, competence, character, or integrity. However, the individual could be placed in a non-senior executive officer position at any institution without any review. If the person is, in fact, performing the duties of a senior executive officer, the appropriate FBA may impose CMPs upon the involved institution for violation of Section 32.

Since it is impractical to monitor each individual's activities, a PCA dismissal-directive should contain a provision requiring FDIC review of the respondent's prospective employment at that institution.

Note: Under Section 38(f)(2)(F)(iii), the FDIC may require an institution to employ qualified senior executive officers who, if the FDIC so specifies, would be subject to approval by the FDIC.