

Chapter 12

Bank Examination and Enforcement

Introduction

The 1980s and early 1990s were undoubtedly a period of greater stress and turmoil for U.S. financial institutions than any other since the Great Depression. Over this period more than 1,600 commercial and savings banks insured by the FDIC were closed or received FDIC financial assistance. As a consequence, the bank regulatory system came under intense scrutiny, and fundamental questions were raised about its effectiveness in anticipating and limiting the number of bank failures and losses to the deposit insurance fund.

Effective supervision can be achieved in two ways: (1) problems can be recognized early, so that corrective measures can be taken and the bank returned to a healthy condition; (2) supervision can limit losses by closely monitoring troubled institutions, limiting their incentives to take excessive risks, and ensuring their prompt closure when they become insolvent or when their capital falls below some critical level.

This chapter reviews and analyzes the bank supervisory system during the 1980s and early 1990s by focusing principally upon bank examination and enforcement policies. The first part surveys the federal agencies' bank examination policies during the 1980s and early 1990s and discusses how changes in bank supervisory philosophy affected examination staffing and frequency, and what the implications of these policies were for losses to the deposit insurance fund. The second part presents a retrospective on the effectiveness of bank supervisory tools used during this period, focusing on the ability to identify troubled banks and the ability to limit risk taking in these institutions by applying enforcement actions. The final part of the chapter discusses the implications for the bank supervisory process of the Prompt Corrective Action (PCA) provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). An appendix describes the bank examination process, including the bank rating system and the nature and types of regulatory enforcement actions.

Bank Supervisory Policies, 1980–1994

Given the constraints imposed on banking activities by the chartering authorities and by legislation and regulation, the primary tools the banking agencies use to ensure the health and stability of the financial system and the solvency of the bank and thrift insurance funds are bank examinations and enforcement actions. Currently there are four basic types of bank examinations. The first focuses on the bank's trust department, to determine whether it is being operated in accordance with established regulations and standards. The second investigates whether the bank is in compliance with various measures designed to protect consumers, such as truth-in-lending requirements, civil rights laws, and community reinvestment regulations. A third type of bank examination focuses on the integrity of the bank's electronic data processing (EDP) systems. Finally and most important, safety-and-soundness examinations focus on five key areas affecting the health of the institution: capital adequacy, asset quality, management, earnings, and liquidity (CAMEL).¹ A bank is rated from 1 to 5 in each area, or component (1 representing the highest rating, 5 the lowest rating). After the overall condition of the bank is evaluated, a composite safety-and-soundness rating, known as a CAMEL rating, is also assigned. A composite CAMEL rating of 1 is given to banks performing well above average. A rating of 2 is given to banks operating adequately within safety-and-soundness standards. A CAMEL rating of 3 indicates below-average performance and some supervisory concerns. Performance well below average yields a CAMEL rating of 4, indicating that serious problems exist at the bank and need to be corrected. Finally, a CAMEL rating of 5 indicates severely deficient performance and the high probability of failure within 12 months. (The appendix includes a detailed description of the CAMEL rating system.) A serious deficiency in any of the areas covered by trust, EDP, and safety-and-soundness exams could lead to failure, but only safety-and-soundness examinations, because of their broad coverage, are discussed here.

Through the early 1970s, all banks—regardless of size and condition—received an examination approximately every 12 months.² But in the middle to late 1970s, bank supervision policy changed significantly, and the change remained in place through the first half of the 1980s. The banking agencies began placing relatively more weight on off-site sur-

¹ As of January 1, 1997, the bank and thrift regulatory agencies added a sixth component to the safety-and-soundness examination, known as the "sensitivity-to-market-risk" component. After that date, therefore, the CAMEL rating system would be referred to as "CAMELS." The new component evaluates how well institutions are prepared to protect bank earnings and capital from shifts in interest rates, in foreign exchange rates, and in commodity prices, and from fluctuations in portfolio values. In this chapter, the sixth component is not discussed.

² The discussion of examination staffing and frequency is partly based on Lee Davison, "Bank Examination and Supervision" (unpublished paper), FDIC, February 1996.

veillance and relatively less on on-site examinations.³ This shift occurred partly because the Call Report data furnished by banks were increasingly comprehensive and partly because sophisticated computer models had been developed for analyzing these data; the increases in comprehensiveness and analytical ability allowed the agencies to make extensive use of off-site surveillance. They viewed off-site analysis as potentially reducing the need for on-site examination visits in nonproblem institutions; it would also reduce examination costs and the burden upon banks. These decisions had widespread implications for subsequent examiner staffing levels and examination frequency, both of which were being reduced during the first half of the 1980s. By the latter half of the decade, however, off-site analysis had become relatively less important in the bank evaluation process vis-à-vis on-site examinations;⁴ and with passage of FDICIA, frequent on-site examinations again became required, this time as a matter of law.

Other important changes in supervisory activity also occurred during the 1980s. Both the Office of the Comptroller of the Currency (OCC) and the FDIC sought to concentrate more examination resources on banks that posed greater systemic risk and relatively less on nonproblem institutions.⁵ All three agencies began cooperative examination programs during the early 1980s.⁶ Both the FDIC and the Federal Reserve System increasingly made use of state bank examinations for nonproblem institutions, often alternating examinations with state regulators in a move to increase efficiency. (See the appendix to this chapter for additional details.)

OCC Policies

The National Bank Act of 1864 mandated that the OCC examine all national banks twice a year but allowed an extension to three examinations every two years. This policy stood until 1974, when the Comptroller of the Currency commissioned a review of the agency's operations from Haskins & Sells, a national accounting firm.⁷ The Haskins & Sells report had a major impact on the theory and practice of federal bank supervision. It criticized the OCC's existing examination policy as inefficient and recommended that the

³ This shift in policy took place primarily at the Office of the Comptroller of the Currency and the FDIC. Although the Federal Reserve System enhanced its off-site surveillance capabilities as well, it did not significantly reduce its commitment to annual examinations for state member banks regardless of size.

⁴ FDIC, *Annual Report* (1990), 20.

⁵ The targeting of problem banks for more frequent examinations and enhanced supervision is documented in John O'Keefe and Drew Dahl, "The Scheduling and Reliability of Bank Examinations: The Effect of FDICIA" (unpublished paper), October 1996.

⁶ The cooperative examination programs primarily meant that the two federal banking agencies that had regulatory oversight of state banks (the FDIC and the Federal Reserve System) accepted state examinations in place of federal examinations if certain conditions were satisfied. In addition, all three federal banking agencies occasionally scheduled joint examinations, and they shared examination information with each other as needed.

⁷ The review was ordered primarily in response to the failure of the United States National Bank.

agency make greater use of statistical, computerized off-site analysis, focus examination resources on weak banks, and, in examinations, put more emphasis on evaluating bank management and systems of internal control and less on doing detailed audits of bank assets.⁸ These recommendations were gradually adopted beginning in 1976, when the OCC extended examination schedules to 18 months for banks with total assets of less than \$300 million.⁹ At the same time, the OCC also established a risk-based examination structure by categorizing banks according to size: multinational, regional, and community.¹⁰

This risk-based structure was further refined under the “hierarchy of risk” policy in 1984. This new approach defined risk categories according to a bank’s size and perceived condition. Resident examiners were placed in the 11 largest multinational banks in 1986, and beginning early in the 1990s some larger regional banks also received resident examiners. In general, on-site resources moved toward the larger institutions and away from smaller banks that were perceived to have no problem. This development was accompanied by the increased use of continuous off-site analysis as well as by the use of targeted examinations (examinations that focused on a particular segment of a bank’s business) rather than full-scope examinations.¹¹

FDIC Policies

Until 1976, the FDIC required that all institutions under its supervision receive a full-scope examination annually. Starting in 1976 and continuing through the early 1980s, the examination schedule was stretched out: only problem banks (those with CAMEL ratings of 4 or 5) were required to receive an annual full-scope examination; banks with lesser problems (CAMEL 3) were to be examined (full scope) at least every 18 months; and banks in satisfactory condition (CAMEL 1 or 2) were to receive either a full-scope or a modified (that is, somewhat less comprehensive) examination at least every 18 months.¹² During the early 1980s, the FDIC also started to emphasize the expanded use of off-site monitoring as

⁸ See OCC, *Haskins & Sells Study: 1974–75* (1975), A2–6. See also Jesse Stiller, *OCC Bank Examination: A Historical Overview*, OCC, 1995, and Eugene N. White, *The Comptroller and the Transformation of American Banking, 1960–1990* (1992), 32–34.

⁹ White, *Comptroller*, 38.

¹⁰ Stiller, *OCC Bank Examination*, 27–28.

¹¹ In 1982, Comptroller C. T. Conover noted that in 1980 the OCC put 70 percent of its effort into examining banks constituting only 20 percent of national bank assets and said the agency had to “examine smarter” by reducing the frequency of on-site examinations of small banks (changing the normal frequency for such banks from 18 months to 3 years) and by supplementing examinations with bank visitations (Linda W. McCormick, “Comptroller Begins Major Revamp,” *American Banker* [April 29, 1982], 15). The movement toward electronic off-site analysis was symbolized by the cake at the OCC’s 120th anniversary celebration in 1983: it was made in the shape of a computer (Andrew Albert, “Comptroller’s Office Throws a Bash,” *American Banker* [November 4, 1983], 16).

¹² FDIC, *Annual Report* (1979), 4. For banks rated 1 or 2 in states where state examinations were accepted, the FDIC allowed alternating federal and state exams (FDIC, *Annual Report* [1980], 8–9).

well as the prioritization of examinations, which were to focus primarily upon problem institutions or those that posed the most risk to the deposit insurance fund. In 1983, the examination interval for nonproblem banks was extended to 36 months. By 1985, problem banks (CAMEL 4- and 5-rated) were to receive examinations every 12–18 months, CAMEL 3-rated banks every 12–24 months, and higher-rated institutions every 36 months, though for banks with less than \$300 million in total assets this could be extended to five years.¹³

By 1986, facing a record number of problem banks, some of which had been highly rated, the FDIC revised its examination policies. The new policy called for all 1- and 2-rated banks to receive on-site examinations at least every 24 months, and all other banks to be examined by either the FDIC or state examiners at least every year. At year-end 1986, 1,814 commercial banks subject to FDIC supervision had not been examined in three years; by 1988 the number was reduced to 197, and by the following year, to 92.¹⁴ With the passage of FDICIA, the return to the examination policies of the 1970s was complete: the law mandated annual on-site examinations of all banks except highly rated small institutions, for which the interval could be extended to 18 months.

Federal Reserve Policies

The Federal Reserve System (FRS) also changed its examination policies in the early 1980s, placing more emphasis on remote surveillance and slightly stretching out examination schedules, but it varied the examination frequency much less than the other agencies did. In 1981, the FRS shifted from a policy of annual examinations for all state member banks to one that allowed the interval to extend to 18 months.¹⁵ This policy remained in place until 1985, when the previous annual requirement for state member banks was reinstated.¹⁶

¹³ FDIC, *Annual Report* (1983), xi; and *Annual Report* (1985), 14–15. The expanded intervals for on-site examinations were paired with the requirement that either bank visitations or off-site reviews be undertaken at least annually for 1- and 2-rated banks, every six months for 3-rated banks, and every three months for 4- and 5-rated banks. Visitations by bank regulators generally involve meetings with bank officials to discuss a variety of issues concerning the bank's operations. Some examples of these issues are compliance with formal and informal corrective orders, progress in correcting deficiencies noted at the previous examination, and any other issues deemed relevant to the sound operations of the bank.

¹⁴ FDIC, *Annual Report* (1988), 2; and *Annual Report* (1989), 8.

¹⁵ FRB, *Annual Report* (1981), 180.

¹⁶ There were gradations to the Federal Reserve policy. Multinational state member banks and all banks with more than \$10 billion in assets were to receive annual full-scope examinations as well as (in most cases) an additional targeted examination. Such examinations had to be conducted either independently by the Federal Reserve or jointly with state authorities. Gradations of smaller banks allowed progressively less Federal Reserve involvement with examinations, but in all cases annual examinations were still mandated. See "Fed Policy for Frequency and Scope of Examinations of State Member Banks and Inspections of Bank Holding Companies," *American Banker* (October 10, 1985), 4–5; on follow-up meetings, see *American Banker* (October 11, 1985), 4.

Examination Staffing and Frequency

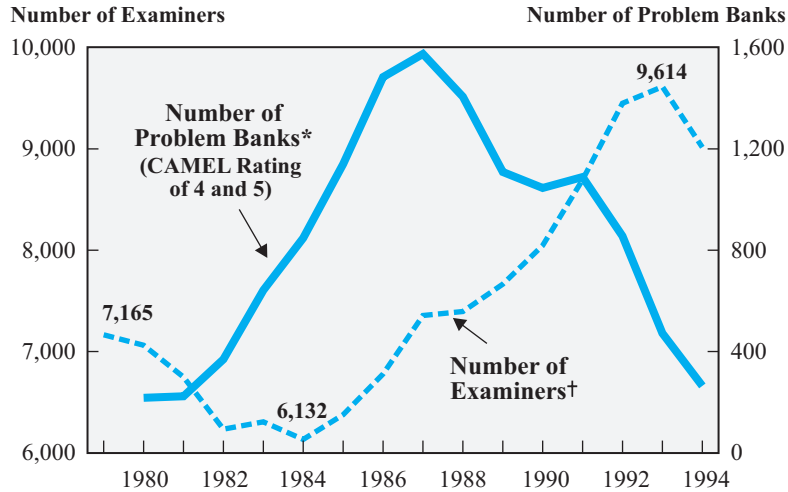
The agencies' shift in supervisory philosophy in the early 1980s, placing more emphasis on off-site analysis and relatively less on on-site examination, had major implications for examination staffing and therefore for the ability to detect problem institutions at early stages. From 1979 through 1984 both the FDIC and the OCC reduced their examiner resources: the FDIC's field examination staff declined 19 percent, from 1,713 to 1,389, and the OCC's declined 20 percent, from 2,151 to 1,722. The Federal Reserve's examination capacity remained almost unchanged. State examiner levels, however, declined, from approximately 2,496 to 2,201. From 1979 through 1984, overall examiner resources at federal and state levels declined by 14 percent, from 7,165 to 6,132 (see figure 12.1).¹⁷

This substantial reduction in staff, especially at the federal level, came about primarily by means of a series of freezes on the hiring of new examiners at the FDIC and the OCC in the late 1970s and the early 1980s; these freezes were consistent with the policies of increased off-site surveillance and with the desire of first the Carter administration and then the Reagan administration to lessen the size of government.¹⁸ As a consequence of the freezes, staff shortages developed in subsequent years and continued until and even beyond the mid-1980s. By year-end 1985, for example, staffing levels at the FDIC were 25 percent below authorized levels. In addition to freezes in hiring, high turnover rates among examiners also helped produce shortages in examiner staffs. The high turnover rates were due in part to the pay differential between the banking agencies and the private sector. Unfilled examiner vacancies persisted until the mid-1980s, when the agencies started to hire new examiners as the number of problem banks increased (rising from 217 to 1,140 between 1980 and 1985—more than a fivefold increase). Thus, during a period of rapidly growing instability in banking with an unprecedented number of problem banks, the agencies' examination staffs consisted of large numbers of inexperienced personnel. As a consequence, experienced staff were forced to devote considerable effort to training new examiners and were correspondingly less available to conduct work on safety-and-soundness examina-

¹⁷ The reduction in examination staff and examination frequency over the period 1981–85 was not a function of a reduced number of banks or assets under supervision by the regulatory agencies. For the OCC, for example, the number of national banks increased from 4,468 to 4,959; total assets under supervision increased from \$1.2 trillion to \$1.6 trillion; and the assets per examiner for all national banks increased from \$668 million to \$910 million. (In Texas, the number of national banks increased from 694 to 1,058.) For the FDIC, the number of state nonmember banks did decline about 5 percent, going from 9,257 to 8,767, but the total assets under supervision increased from \$589 billion to \$805 billion, and the assets per examiner increased from \$355 million to \$520 million. (In Texas, the number of state nonmember banks actually increased slightly, going from 786 to 808.) For the Federal Reserve, the total number of state member banks increased from 1,020 to 1,070; the total assets under supervision increased from approximately \$387 billion to \$495 billion; and assets per examiner grew from \$484 million to \$593 million. (There were only a small number of state member banks in Texas.)

¹⁸ Under the directives of the Reagan administration in 1981, the OCC instituted a hiring freeze for all examiners. The FDIC, as an independent agency, was under no legal obligation to follow suit but chose to freeze its examination staff in 1981. In the late 1970s, the Carter administration had also attempted to limit the size of the federal work force.

Figure 12.1
Field Examination Staffs of the Federal and State
Banking Agencies, and Total Number of Problem Banks,
1979–1994



Sources: FDIC, FRB, OCC, and Conference of State Bank Supervisors.

* Because problem banks were not classified as those having 4 and 5 CAMEL ratings until 1980, the number of problem banks for 1979 is not included.

† Total number of examiners includes all federal and state bank regulators.

tions.¹⁹ From 1986 to 1992, for example, approximately half of the supervisory staff at the FDIC consisted of assistant examiners with less than three years' experience.

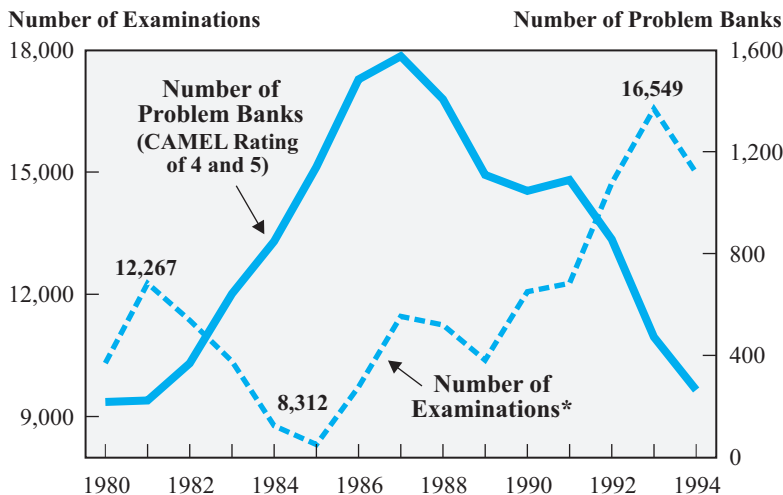
Furthermore, as problem banks multiplied in the Midwest and Southwest, resources were shifted from areas with seemingly healthy banks, such as the Northeast. Experienced FDIC examiners in the Northeast routinely spent a quarter of their time out of the region assisting with problems elsewhere. Moreover, as bank failures increased, bank examination personnel were detailed to support bank resolution activities. In 1984, the FDIC deployed 11 percent of its total examination staff time to such matters. This shift of resources among regions and across functions placed additional pressure on the examination force's ability to detect problem banks, especially in a seemingly healthy area like New England, where a crisis was about to erupt.

¹⁹ The training cycle for newly hired examiners is lengthy and complicated; approximately three to five years are required before a new hire is a fully trained, commissioned examiner.

The reduction in examination staff, as mentioned above, was partly a side effect of the agencies' decision to reduce the number of bank examinations and increase the median interval between examinations. The total number of examinations declined from a high of approximately 12,267 in 1981 to a low of approximately 8,312 in 1985, a drop of more than 30 percent (see figure 12.2). By far the largest decline occurred at state nonmember banks, where on-site examinations decreased more than 40 percent, from approximately 8,000 in 1981 to approximately 4,600 during 1985. Declines were more moderate for national banks and state member banks: both declined less than 15 percent during the same period. In addition to frequency, the scope of examinations was also curtailed, as limited resources gave the agencies no option but to continue to modify their examination procedures.

Reductions in examination frequency are tantamount to extensions of examination intervals. Between 1979 and 1986, the mean examination interval in days for all commercial and savings banks increased dramatically from 379 to 609 (see table 12.1). The intervals were increasing for all CAMEL rating categories, but especially for highly rated institutions. For 1-rated banks, the interval increased from 392 to 845 days; for 2-rated banks, from 396 to 656 days. The interval also grew for poorly rated institutions, but not as much.

Figure 12.2
Total Number of Examinations per Year
and Total Number of Problem Banks, 1980–1994



Sources: FDIC, FRB, and OCC.

* Total number of examinations includes all examinations conducted by federal agencies and all state examinations accepted by federal authorities.

Table 12.1
Mean Examination Interval for Commercial Banks,
by CAMEL Rating, 1979–1994
(Days)

Year	Composite CAMEL Rating					All Banks
	1	2	3	4	5	
1979	392	396	338	285	257	379
1980	456	460	402	312	286	450
1981	493	482	342	279	236	472
1982	459	446	321	262	249	434
1983	500	450	309	261	243	436
1984	620	499	327	303	270	480
1985	761	596	369	324	284	564
1986	845	656	407	363	313	609
1987	754	597	386	354	284	556
1988	615	497	376	339	315	477
1989	562	487	373	324	296	466
1990	463	436	331	303	270	411
1991	420	412	323	286	273	385
1992	409	396	319	291	278	373
1993	400	379	296	286	232	363
1994	380	357	296	279	245	354

Sources: FDIC, FRB, and OCC.

For 4-rated banks, the interval increased from 285 to 363 days; for 5-rated banks, from 257 to 313 days. These data indicate that the regulatory policy in the early 1980s of focusing more resources on the examination of troubled banks and thus reducing examination intervals for these organizations was generally not being carried out successfully.²⁰

Data on examination intervals by bank regulatory agency show that for the period 1980–86, overall examination intervals increased for all three agencies (see table 12.2). For the OCC, the interval increased about 45 percent, or from 417 to 604 days. For the FDIC, 37 percent, or from 460 to 628 days. The increase for banks supervised by the Federal Reserve was a more modest 27 percent, from 411 to 520 days.

The reductions in examination frequency were most pronounced in the Southwest, particularly Texas, which had the largest concentration of problem and failed banks and

²⁰ A study specifically of Texas banks reaches the same conclusion (John O’Keefe, “The Texas Banking Crisis: Causes and Consequences 1980–1989,” *FDIC Banking Review* 3, no. 2 [1990]: 12).

Table 12.2
Mean Examination Interval for Commercial Banks,
by Regulatory Agency, 1980-1994
(Days)

Year	OCC	FDIC	FRS
1980	417	460	411
1981	521	451	502
1982	468	415	503
1983	469	415	514
1984	529	446	503
1985	567	568	532
1986	604	628	520
1987	511	580	516
1988	552	452	461
1989	589	415	461
1990	482	379	439
1991	445	356	414
1992	422	351	404
1993	433	333	386
1994	395	333	401

produced the greatest losses to the insurance fund.²¹ In Texas, for example, the average number of examinations for all banks declined from a high of more than 1,200 in 1983 to approximately 600 at year-end 1985 (see figure 12.3). This decline is reflected in the median number of days between examinations for all failed banks in the region (see figure 12.4). In the Southwest as a whole, the median interval for failed banks reached a high of 579 days in 1986; for failed Texas banks, it reached 667 days. The average for all U.S. banks that failed in the same year was substantially lower: 455 days.

Bank examination staffs and examination frequency continued to increase during the second half of the 1980s and into the 1990s, as all of the agencies attempted to deal with the backlog of problem banks. In 1993 the number of field examiners reached a high for all federal and state agencies (9,614), up more than 30 percent over the number in 1979 (figure 12.1). In addition, the total number of examinations began trending upward beginning in 1985, until by the early 1990s the number of annual examinations reached the levels of the

²¹ For a more complete discussion of the issue of examination frequency in Texas and the Southwest during the 1980s, see O’Keefe, “The Texas Banking Crisis,” 1–14.

Figure 12.3
Average Number of Examinations per Year for Texas Commercial Banks, 1980–1994

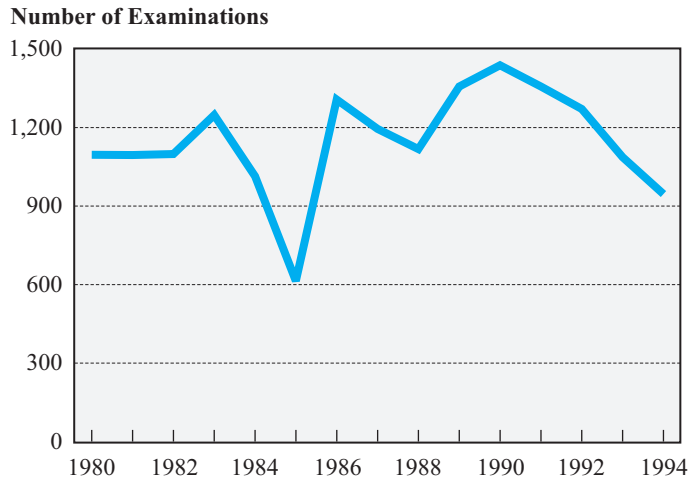
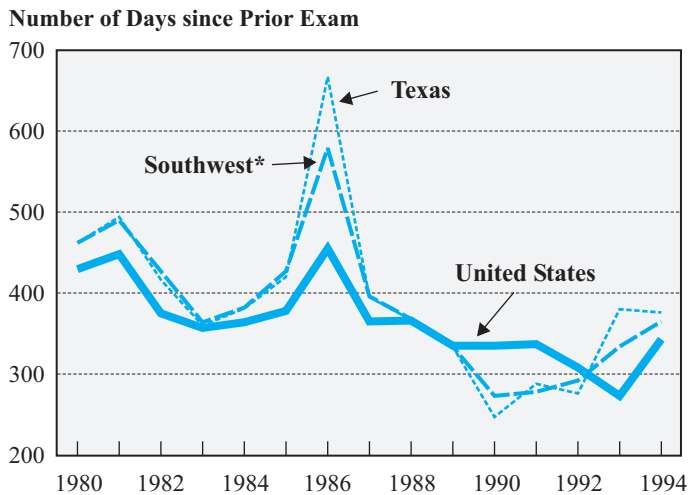


Figure 12.4
Median Examination Period (Days) for Failed Banks, 1980–1994



*The Southwest region includes Arkansas, Louisiana, New Mexico, Oklahoma, and Texas.

early 1980s (figure 12.2). The passage of FDICIA in 1991, therefore, reinforced a trend that had already begun. The data show that bank regulators had recognized the need for more frequent examinations and had begun moving in that direction.

In summary, the decisions that caused examiner levels to be reduced during the first half of the 1980s were a public policy failure. Such policies reduced the ability of supervisors to detect problems early enough to take corrective action. This was especially true in Texas and the Southwest, where the economy was changing rapidly and the number of problem banks was increasing. It is reasonable to assume, although impossible to demonstrate empirically, that if examination frequency had not been reduced, problems would have been detected earlier and losses to the insurer reduced.²² But the reduced frequency of examinations did more than limit the usefulness of information derived from examinations. It also limited the usefulness of the financial reports used in off-site monitoring: on-site examiners are able to evaluate the quality of the loan portfolios and verify the data reported by banks on nonperforming loans and loan charge-offs. Thus, if examinations are less frequent, Call Report data are less reliable—and the off-site monitoring systems that are based on Call Report data are less able to predict future problems.²³

Examination Ratings and Reports: Effectiveness in Identifying Troubled Banks

To identify and control risk in troubled institutions, bank supervisors have essentially two types of tools: on-site bank examinations and follow-up enforcement actions. (See the appendix for a description of the examination and enforcement process.) The aim of the on-site examinations is, by means of the rating system, to identify the risk of failure in troubled institutions in sufficient time for supervisors to take corrective action. The aim of the follow-up enforcement actions is to control the risk-taking behavior of problem banks after they have been identified.

Regular on-site safety-and-soundness examinations that identify potential problem banks early and appraise their financial condition accurately are bank supervisors' primary vehicle in identifying troubled banks, and the analysis in this chapter shows that for most failed banks that had had recent examinations, ratings generally did a satisfactory job of identification well in advance of failure.²⁴ Nevertheless, some omissions in the supervisory system were apparent, for examination ratings sometimes gave an inaccurate picture of a bank's con-

²² Several empirical studies have demonstrated that with more frequent examinations, problem banks would have been detected earlier. See especially O'Keefe and Dahl, "Scheduling and Reliability."

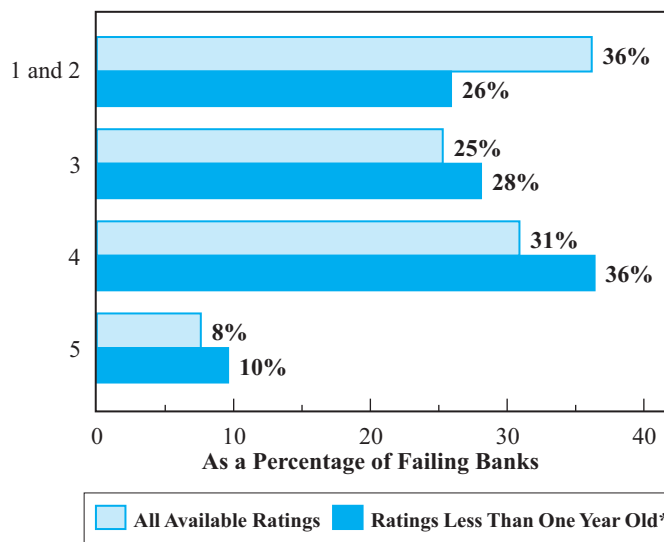
²³ See Drew Dahl, Gerald A. Hanweck, and John O'Keefe, "Audits, Exams and Accounting Integrity in Banking" (unpublished paper), February 1995; and R. Alton Gilbert, "Implications of Annual Examinations for the Bank Insurance Fund," Federal Reserve Bank of St. Louis *Economic Review* 75, no. 1 (1993): 35–52.

²⁴ A "recent" examination is one generally given within the preceding 12 months.

dition until relatively shortly before failure. The record shows that 260 failed banks were not identified as requiring increased supervisory attention within 24 months of failure. Of these, 141 were not detected as troubled banks within 18 months of failure; 57 were not detected within 12 months of failure; and 9 were not detected within 6 months of failure.

Bank examination ratings two years before failure for all failed banks are shown in figure 12.5.²⁵ These data refer to examinations available two years before failure, including those that were already several years old.²⁶ The two-year interval was selected because FDIC bank supervisors believe that the examination system should uncover signs of potentially serious deficiencies in the financial condition of a bank within at least 24 months of

Figure 12.5
Composite CAMEL Ratings Two Years before Failure for Banks Failing between 1980 and 1994



* Ratings that were less than one year old as of the two-years-before-failure date; that is, ratings based on examinations dated between two and three years before failure.

²⁵ All examinations cited were regular full-scope or modified-scope on-site safety-and-soundness examinations. Consumer compliance, EDP, and other types of non-safety-and-soundness examinations were not included in the analysis.

²⁶ The analysis accounts for examination ratings that existed two years before failure. However, many of the examinations that were on the books two years before failure were several years old at that time.

failure. The data show that within two years of failure, 36 percent of the banks that failed had the highest ratings (a 1 or 2 rating), 25 percent had a 3 rating, 31 percent a 4 rating, and only 8 percent a 5 rating. Examination ratings did, therefore, identify nearly two-thirds of the total 1,617 failures as in need of increased supervisory attention (CAMEL 3, 4, or 5 ratings) at least two years before failure.

Nevertheless, a significant number of cases went undetected in the early stages: overall, 565 banks, or approximately 36 percent of those banks that eventually failed, held a satisfactory 1 or 2 rating two years before failure. Several factors may have contributed to the inability of the supervisory process to identify these banks. For example, some of these banks might have deteriorated quickly or might not have been examined recently. An alternative explanation is that the examinations failed to detect the problems.²⁷ An analysis of the lack of supervisory identification of these 565 banks demonstrates that the most significant factor was outdated examinations (see table 12.3). In approximately 34 percent of these cases (194 banks), the existing examination ratings available two years before failure were more than one year old at that time. If only examination ratings that were less than one year old at that time are counted, the proportion of banks with 1 and 2 ratings two years before failure declined from 36 percent to 26 percent, and the proportion of banks with CAMEL3,

Table 12.3
Failing Banks with CAMEL Ratings of 1 or 2 Two Years before Failure, 1980–1994

	Number	Percent of Total Failures
Total 1- and 2-rated future failures	565	35%
Specific types:		
Cross-guarantee cases	25	
Failures associated with fraud	24	
First City Bancorporation affiliates	36	
First RepublicBank Corporation affiliates	26	
CAMEL ratings more than one year old*	194	
Total of above	305	19
Remaining 1- and 2-rated future failures	260	16

* Failures of banks with ratings more than one year old (two years before failure) do not include cross-guarantee cases, failures associated with fraud, First City Bancorporation affiliates, or First RepublicBank Corporation affiliates.

²⁷ The majority of the 565 banks were relatively small and were concentrated in a few geographic areas: approximately 80 percent of them held total assets of less than \$100 million, and almost 70 percent of them were located in the Midwest or the Southwest. In addition, almost all were either national or state nonmember banks.

4, and 5 ratings (those identified as exhibiting various degrees of weakness) rose from 64 percent to 74 percent of the institutions that would fail two years later. (See table 12.5).

These findings are consistent with the supervisory policies adopted by the banking agencies during the 1980s. This was a period when most banking agencies had cut examination staffs, were placing more reliance on off-site monitoring based on Call Report data, were concentrating their examiner resources on the most troubled banks, and, in the case of the FDIC, were using existing supervisory personnel increasingly to assist in closing and liquidating failed banks. In many cases these changes had reduced the ability of bank supervisory examiners to detect financial problems early enough to prevent failure.²⁸

But in addition, the failure to give sufficient warning for some of the 1- and 2-rated banks was caused by safety-and-soundness conditions for which the CAMEL system was not designed. Of the 565 banks, 25 were cross-guarantee failures pursuant to the provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), and bank examiners could not have been expected to know two years in advance that the FDIC would decide to invoke this provision.²⁹ Another 24 failures were associated with bank fraud, a problem that is difficult to detect and one that bank examiners are not trained to uncover. In some cases, bank fraud can—and in these cases did—result in the quick closing of otherwise healthy banks.³⁰ Finally, 62 banks failed when the lead banks of two large Texas bank holding companies, First City Bancorporation and First Republicbank Corporation, collapsed. In economic terms, these affiliates were more like branches than independent banks, and CAMEL ratings for the affiliates did not reflect the condition of the parent companies. More important, the banking agencies were not dependent on CAMEL ratings for information on these two holding companies; their situation had been under consideration for a protracted period. Thus, when these failures are excluded, 260 banks, or ap-

²⁸ These findings are supported by the research of Dahl, Hanweck, and O’Keefe (“Audits,” 18–20), who show that during the period 1987–94, bank regulatory authorities directed their examination resources primarily at banks that had the lowest examination ratings. They concluded that “examinations appear to have been consistently targeted at banks with the worst performance as indicated by prior CAMEL ratings or nonperforming loan experience” and that “losses are higher with longer gaps between examinations.”

²⁹ The FDIC’s “cross-guarantee” program generally assesses all banks in the holding company for the FDIC losses of individual members. In some cases, this assessment results in the closing of all banks in the holding company, but the end result is to reduce the insurer’s losses.

³⁰ The precise role that fraud and financial misconduct played as a cause of bank failures during the 1980–94 period is difficult to assess. The consensus of a number of studies is that fraud and financial misconduct (1) were present in a large number of bank and thrift failures in the 1980–94 period; (2) contributed significantly to some of these failures; and (3) were able to occur because of the same managerial deficiencies and inadequate internal controls that contributed to the financial problems of many failed and problem institutions in the first place. With respect to the last issue, the conclusion appears to be that internal weaknesses left the institutions vulnerable to both abuse and fraud as well as to adverse economic developments. The studies also found that for many reasons it is very difficult to estimate the dollar impact of such activity. For a more detailed discussion of the relationship between bank failures and fraud, see Chapter 1.

proximately 16 percent of the 1,617 failures that occurred during the period, were not detected by the supervisory system two years before failure.³¹

An analysis also was undertaken to determine whether examiners were more effective in identifying, within two years of closing, relatively larger-sized banks that failed. After outdated examinations were eliminated and additional adjustments were made for the reasons previously discussed, the results show that approximately 15 percent of banks that received 1 or 2 ratings within two years of failure and had total assets of over \$250 million were not identified. This compares to 16 percent for the total group that is presented in table 12.3.³² These findings by themselves do not provide evidence that examiners were substantially better at identifying risk in larger-sized banking organizations two years before failure than they were with all banks that failed.

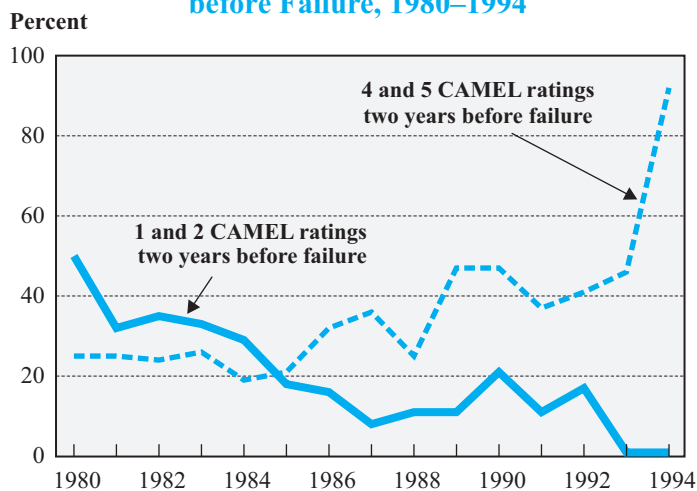
A further investigation was conducted to determine if the CAMEL rating system of risk identification improved incrementally over the period 1980–94. As mentioned above, additional examination resources were being made available to the bank regulatory agencies during the middle to late 1980s, and examination frequency increased substantially during this period. Thus, the detection of problem banks should have been improving over this period. To test for this effect, the 260 banks that were rated 1 or 2 within two years of failure were broken out by year and weighted by the total number of failures within each of the years from 1980 to 1994. The data show that from 1980 to 1986 approximately 28 percent of total failures, on average, had a CAMEL rating of 1 or 2 two years before failure. From 1987 to 1994, however, the comparable figure was only about 12 percent of total failures. The difference in means for the two time periods for the 1- and 2-rated group was statistically significant at the 99 percent confidence level. The analysis was also conducted for failed banks that had a 4 or 5 rating two years before failure. The data show that from 1980 to 1986, 25 percent of banks that failed had a 4 or 5 rating within two years of failure. From 1987 to 1994, however, the comparable figure was 46 percent. The difference in means for this group for the different time period was also statistically significant at the 99 percent level.

These data are presented in figure 12.6, which charts the improving accuracy of the CAMEL rating system in identifying problem banks after 1985. The improvement in the rating system's effectiveness was partly a function of the increasing frequency of bank examinations starting in the second half of the 1980s. In summary, given the turmoil and the

³¹ Exclusion of banks with ratings that were more than one year old two years before failure means, in effect, that the data refer to examinations conducted between two and three years before failure.

³² The 1,617 failures during the period 1980–94 included 156 banks with total assets over \$250 million. Of these 156 banks, 47 had a 1 or 2 rating two years before failure, while 103 had a 3, 4, or 5 rating. Six of the other banks were not counted, because examination information on them was unavailable in electronic form. Of the 47 1- or 2-rated banks, 24 were discarded for the reasons discussed in connection with table 12.3. Thus, 23 of a total of 150 large banks were not identified by the examiners two years before failure.

Figure 12.6
CAMEL Ratings of Failed Banks Two Years
before Failure, 1980–1994



regional banking crises of the 1980s and early 1990s, overall CAMEL ratings (when they were current) appear to have done a reasonably satisfactory job of focusing attention on most of the institutions that subsequently failed.

Limitations of the CAMEL Rating System

Although the CAMEL ratings identified most failed banks that had had examinations within two years of failure, the rating system suffers from some limitations. First, the ratings did not necessarily capture the seriousness of the situation of banks that subsequently failed. For example, if only officially designated problem institutions (those with 4 or 5 ratings) are discussed, then the system identified only 46 percent of the banks in that group that failed within two years (figure 12.5). Second, because CAMEL ratings are based only on internal operations, they measure only the current financial condition of a bank and do not take into account regional or local economic developments that may pose future problems but that are not yet reflected in the bank's condition.³³ Third, CAMEL ratings by design are not forward-looking and do not systematically track long-term risk factors that may cause losses several

³³ In light of the various regional economic recessions and banking crises of the 1980s and early 1990s, most bank regulatory agencies were more careful about monitoring regional economic conditions starting in the mid-1990s and attempted to incorporate the analysis of these conditions into the bank examination process. For example, in late 1995 the FDIC established the Division of Insurance, which monitors regional economic conditions and other potential risks to commercial banks and works closely with the Division of Supervision.

years later. Thus, the picture they provide of a bank's condition is current rather than prospective.³⁴ For example, many banks during the period under review engaged in risky behaviors that in the past had been associated with failures, like excessive asset growth, high ratios of commercial real estate loans and total loans to total assets, or a heavy dependence upon volatile deposit liabilities, yet if the bank was performing satisfactorily, these risk factors were generally not captured or weighted in the current examination ratings.

Fourth, while not a limitation of the rating system per se, the frequent use of on-site bank examinations that are designed to limit future bank failures imposes a burden on depository institutions, which must absorb their costs and contend with the disruption they impose on the work environment. This can be particularly burdensome during good economic times, when the condition of most banks is reasonably healthy and examination ratings change relatively little. For example, an average of less than 15 percent of examination ratings resulted in downgrades each year during the period 1980–94, although the number varied significantly depending on region, especially during deep recessions.³⁵

The burden of on-site examinations may also be illustrated by the fact that even most banks that are designated as problem banks (CAMEL 4 or 5 rating) do not fail.³⁶ It can be argued either that this is a defect of the rating system as a means of forecasting failures or, conversely, that examination ratings trigger the supervisory responses that prevent troubled banks from failing or reduce failure costs when the banks have to be closed. It must be recognized, however, that both the large number of banks whose ratings do not change through repeated examinations and the large number of troubled banks that do not fail are unavoidable consequences of having frequent on-site examinations. Given that on-site examinations provide information to the regulators that is otherwise unavailable, these consequences must be borne if the condition of insured banks is to be monitored effectively.

³⁴ There may be some exceptions, however. While the overall or composite rating is not forward-looking, some examination component ratings, like that of management (M), may be forward-looking and may yield information about the future risk of failure. For example, a poor management component rating may indicate that the bank suffers from weak internal controls, unsatisfactory underwriting policies, or other deficiencies that could threaten the solvency of the bank. Deterioration in this component may yield information about future risk. To test this proposition, researchers at the FDIC evaluated the management component ratings for the 1,564 banks (excluding assistance cases) that failed between 1980 and 1994. The results show that two years before failure, in only 6 percent of the cases was the management rating one full number worse than the average of the other four components.

³⁵ Bank examination ratings can change rapidly as banks' conditions change during deep recessions, like those experienced in the Southwest in the late 1980s and in New England in the early 1990s. In the Southwest during the years 1985–89, for example, 34 percent of the banks that were examined recorded ratings downgrades. In the New England states between 1989 and 1992, 29 percent of the banks that were examined recorded ratings downgrades. For further discussion of this issue, see Rebel Cole and Jeffery W. Gunther, "A CAMEL Rating's Shelf Life," Federal Reserve Bank of Dallas *Financial Industry Studies* (December 1995): 13–20.

³⁶ Most of these banks do not fail in the sense of causing losses to the insurer. However, a large percentage survived only through the acquisition by or merger with another organization.

Monitoring: Measures of Effectiveness in Limiting the Risk-Taking Behavior of Troubled Institutions

Identifying problem banks early is one responsibility of bank supervisors. Another is to monitor the behavior of troubled institutions in an attempt either to prevent failure or to limit losses to the insurance fund in the event of a closing.³⁷

As an insured depository's capital is depleted, it has less to lose from pursuing high-risk investment strategies in an attempt to return to profitability. The institution's owners or managers may be tempted to engage in speculative lending or to assume greater-than-normal interest-rate risk. They may also make inappropriate dividend payments or engage in other fund transfers. Such behavior contributed significantly to the cost of resolving failed thrift institutions during the 1980s. Marginally capitalized (or insolvent) thrifts undertook high-risk ventures that ultimately increased losses to the thrift insurance fund, and it is widely believed that ineffective monitoring and supervision—as well as the regulators' inability to close insolvent thrifts due to inadequate funds—permitted them to do so.³⁸ However, neither existing empirical studies of banking nor the findings presented in this chapter have found widespread evidence of such behavior at marginally capitalized banks.³⁹

One measure of the effectiveness of the supervisory monitoring program is the number of problem banks that recovered without cash assistance by the insurer. From 1980 to 1994, there were 4,808 institutions that were classified as either a 4- or a 5-rated bank sometime during the period. Of this total, 1,311 (27 percent) failed, while 3,497 (73 percent) ei-

³⁷ The following studies analyze the effectiveness of supervisory oversight of problem banks: French, "Early Corrective Action," 1–12; David K. Horne, "Bank Dividend Patterns," *FDIC Banking Review* 4, no. 2 (1991): 13–24; R. Alton Gilbert, "Supervision of Undercapitalized Banks: Is There a Case for Change?" *Federal Reserve Bank of St. Louis Review* 73, no. 3 (1991): 16–30; and R. Alton Gilbert, "The Effects of Legislating Prompt Corrective Action on the Bank Insurance Fund," *Federal Reserve Bank of St. Louis Review* 74, no. 4 (1992): 3–22. Studies that have found formal enforcement actions to be effective in altering the behavior of problem banks are Joe Peek and Eric S. Rosengren, "Bank Regulatory Agreements and Real Estate Lending," *Real Estate Economics* 24 (1996): 56–73; and U.S. General Accounting Office, *Bank Supervision: Prompt and Forceful Regulatory Actions Needed*, report to the Chairman, House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, April 1995.

³⁸ In some instances, thrift regulators encouraged certain types of risky behaviors, like high growth rates, which they thought would permit thrifts to grow out of their problems. For research documenting the existence of the so-called moral-hazard problem associated with the behavior of thrift institutions during the 1980s, see James R. Barth, Philip F. Bartholomew, and Carol Labich, "Moral Hazard and the Thrift Crisis: An Analysis of 1988 Resolutions," in *Proceedings of the Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, May 3–5, 1989, 344–84; and Gillian Garcia, "The FSLIC Is 'Broke' in More Ways Than One," *Cato Journal* 7, no. 3 (1988): 727–41.

³⁹ For example, Gilbert ("Supervision of Undercapitalized Banks") found that undercapitalized banks during the period 1985–89 generally did not grow rapidly, pay dividends, or make loans to insiders, all of which are behavioral patterns normally associated with high-risk strategies. Moreover, Gilbert ("Legislating Prompt Corrective Action") also found no relationship between resolution cost and either the level of capital one year before failure or the length of time a bank was undercapitalized.

ther survived as independent banks, were purchased by bank holding companies, or merged into other banks without FDIC assistance. Therefore, approximately three out of four problem banks recovered without assistance.

The behavioral changes of all problem banks for three years before either failure (for failed banks) or the date of recovery (for the problem banks that survived) are presented in table 12.4. The data show that 4- or 5-rated banks slowed down their asset growth, cut dividend payments, and generally increased capital from external sources.⁴⁰ These trends are consistent over the three-year observation period for both problem banks that failed and problem banks that survived. Furthermore, these trends became more pronounced with the evolution of the various banking crises, as supervisors received additional examination resources during the second half of the 1980s, gained more experience dealing with the heavy volume of problem banks, and became more aggressive in constraining the risky behavior.

Table 12.4
Asset Growth Rates, Dividend Payments, and Capital Injections,
All Banks with CAMEL Ratings of 4 or 5, 1980–1994

Years before Failure, Recovery, or Merger	Failed Banks			Surviving Banks			Total (Failed and Surviving)		
	Year of Failure			Year of Recovery or Merger*			Year of Failure, Recovery, or Merger*		
	1980–85	1986–91	1992–94	1980–85	1986–91	1992–94	1980–85	1986–91	1992–94
A. Asset Growth Rate (Percent)									
3	14.60	15.65	18.77	10.39	13.38	4.42	11.91	14.09	5.93
2	10.72	1.71	–3.53	3.67	1.25	–0.61	6.21	1.40	–0.92
1	0.91	–10.17	–13.39	1.96	0.96	–0.64	1.58	–2.51	–1.98
B. Dividends to Average Assets (Percent)									
3	0.34	0.21	0.09	0.20	0.21	0.13	0.25	0.21	0.13
2	0.32	0.16	0.06	0.16	0.14	0.09	0.22	0.15	0.09
1	0.16	0.05	0.02	0.13	0.13	0.08	0.14	0.11	0.07
C. Capital Injections to Average Assets (Percent)									
3	0.18	0.42	0.45	0.19	0.46	0.42	0.19	0.45	0.42
2	0.22	0.52	0.54	0.39	0.56	0.42	0.33	0.55	0.43
1	0.65	0.39	0.40	0.44	0.45	0.49	0.51	0.43	0.48

Note: Data are unweighted averages of individual bank percentages.

* Recovery is either the date of a bank's unassisted merger or, if the bank survived as an independent institution, the date it received a CAMEL rating of 1, 2, or 3.

⁴⁰ Capital injections include new stock issues, capital contributed through merger, and capital contributed from parent holding companies.

(The data are broken out for three different time intervals during the period 1980–94, each reflecting a different stage of the banking crisis: the early [1980–85], the middle [1986–91], and the late [1992–94] periods.)⁴¹

The findings show, therefore, that the moral-hazard problem was being contained, for banks were shrinking their assets over this period. In the case of surviving banks, reduced dividend payouts and increased capital injections helped restore equity positions and were instrumental in facilitating recovery. In the case of failed banks, dividend cuts and new capital had the effect of reducing the costs of failure. Thus, the end result of changes in the operation of problem banks appears to have been a reduced number of bank failures, a reduction in risk taking at troubled banks, and a reduction in losses to the fund—whether the changes were due to management, stockholders, market forces, or bank supervisors.⁴²

Number and Kinds of Formal Enforcement Actions

To achieve effective oversight, banking authorities need adequate supervisory powers to limit potential risk-taking behavior by undercapitalized banks. The ability to identify problem banks is of limited usefulness without adequate authority to compel corrective actions. Most regulatory agencies have sufficient power to improve capital, levy fines, remove management, restrict dividends and other inappropriate funds transfers, and restrict riskier lending and excess asset growth. Bank chartering authorities also have the power to appoint a conservator or receiver, and the FDIC has the power to terminate or suspend deposit insurance.

The risk-control activity that begins with the examination process may be completed by enforcement actions both informal and formal. Informal actions are usually assigned when a bank receives a CAMEL 3 rating. At this time the agency generally receives a written commitment from bank management to take corrective action; the commitment is in the form of a memorandum of understanding (MOU) or a bank board resolution. Formal actions, which are legal decrees and legally enforceable in the courts, are usually taken when

⁴¹ The “early period” was a time when most of the banking agencies were cutting examination staffs, while the number of problem banks was increasing significantly. The “middle period” was when the majority of the bank failures were occurring. The “late period” corresponded to a change in regulatory regime after the passage of FDICIA in 1991.

⁴² J. Kimball Dietrich and Christopher James argue that higher capital injections of weaker banks were not the result of supervisory pressure but the result of actions taken by the banks and the equity markets. Such a position appears unrealistic because, from whatever source, the urgency to raise capital nonetheless reflects a desire to avoid closure or other sanctions. The capital injection can therefore probably be considered a result of the supervisory system. See Dietrich and James, “Regulation and the Determination of Bank Capital Changes: A Note,” *Journal of Finance* 38, no. 5 (1983): 1651–58. It should be noted that new legal and institutional constraints were being put into place starting in the late 1980s to control the incidence of moral hazard in banking. Minimum and risk-based capital standards were in place at least since the late 1980s; the least-cost test for resolving bank failures, Prompt Corrective Action, and risk-based insurance premiums originated with the passage of FDICIA in 1991. All of these actions were intended to minimize moral hazard and to place more of the risk of loss on the shareholders of institutions and less on the U.S. taxpayer and the deposit insurance fund.

a bank's deterioration is more serious and it receives a 4 or 5 rating. Formal actions include cease-and-desist orders and/or suspension or removal of bank officers or directors. Civil money penalties—fines—may be imposed on depository institutions for failing to meet the terms of cease-and-desist orders or for violating federal or state laws or regulations, and these fines are often heavy.⁴³

FDIC formal enforcement actions. During the 1970s, the FDIC did not widely use formal supervisory enforcement actions. The agency was first given authority to issue cease-and-desist orders and removal authority under the FDI Act as amended in 1966, and during the first half of the 1970s the agency issued only 37 orders. Over the next four years, however, the agency became more aggressive, issuing 176 orders primarily under Sections 8(a) and 8(b) of the FDI Act as amended. These sections deal with termination of insurance and cease-and-desist orders. During the 1980s, as the number of problem banks increased dramatically, so also did the number of formal actions brought against FDIC-supervised banks. The number of formal actions issued by the FDIC for safety-and-soundness purposes grew quickly in the early 1980s, and peaked in 1985 at 272 (see table 12.5).⁴⁴ From 1986 through 1990, as the number of problem banks declined, the issuance of formal actions also declined, with an annual average of approximately 168. But the growing number of problem banks in New England again brought an increase in the number of FDIC formal actions, with an annual average of 200 issued in 1991–92. During the following years, the numbers of actions declined as the economy improved and commercial bank earnings rebounded.⁴⁵

The greatest proportion of actions were brought against 4-rated banks, which accounted for over half of all formal actions. Generally such institutions suffer from serious problems but are usually salvageable. An additional 35 percent of the total were issued against 5-rated banks. CAMEL 5-rated banks are thought to have substantial risk of failing within one year. Actions against these banks are intended to correct the problems if possible, but if the institution is too ill to recover, the objective is to limit losses before failure. A smaller number of actions (159) were brought against highly rated (1- and 2-rated) banks. Over half of these actions dealt with the removal and suspension of officers and directors.⁴⁶

⁴³ Formal enforcement actions are issued by all federal banking agencies, but OCC data on enforcement actions brought against troubled banks were not available for this analysis. Thus, only formal actions against FDIC-supervised and Federal Reserve-supervised banks are analyzed.

⁴⁴ FDIC enforcement actions brought against state banks in all categories from 1980 to 1995 (including not only safety and soundness but also violations of consumer laws and regulations, trust, and EDP, and other miscellaneous categories) amounted to 3,041.

⁴⁵ The data on FDIC-issued informal actions are available only from 1992. The number totaled 750 for 1992, 616 for 1993, and 472 for 1994 for all other categories.

⁴⁶ The reasons for the actions taken against the other 1- and 2-rated banks are unknown at this time.

Table 12.5
FDIC Formal Enforcement Actions by Examination Rating, 1980–1995

Year	Number	CAMEL Rating at Examination before Enforcement Action				
		1	2	3	4	5
1980	47	1	3	1	32	10
1981	38	2	6	1	22	7
1982	93	1	4	4	56	28
1983	238	0	4	4	166	64
1984	184	2	5	9	103	65
1985	272	1	9	6	164	92
1986	174	0	4	1	89	80
1987	197	1	2	6	92	96
1988	175	0	3	5	78	89
1989	156	0	4	6	76	70
1990	137	0	4	4	73	56
1991	203	0	10	11	110	72
1992	197	0	15	14	126	42
1993	140	2	13	27	59	39
1994	85	8	29	9	18	21
1995	62	3	23	7	17	12
Total	2,398	21	138	115	1,281	843

Note: Formal enforcement actions for safety-and-soundness purposes only. □

The largest number of formal enforcement actions brought by the FDIC, accounting for over 60 percent (1,485) of the total number of actions, consisted of Section 8(b) actions, or the issuance of cease-and-desist orders (see table 12.6). These actions are generally issued to curb unsafe banking practices like insider abuses, unsound underwriting practices, inaccurate loan-loss reserve accounting, unwise dividend policies, and other types of unauthorized fund transfers. Other major enforcement categories include Section 8(a) proceedings for termination of insurance, and Section 8(e) removals of officers, directors, and other principals; actions in those two categories accounted for an additional 32 percent (763) of the total. Miscellaneous actions make up the remainder.⁴⁷

Table 12.7 shows the number of FDIC-supervised problem banks from 1980 to 1994 and their resultant status as either failed or surviving. These data show that of the 2,826

⁴⁷ The number of formal enforcement actions for safety-and-soundness purposes excluded civil money penalties because it could not be determined if the actions were related to safety-and-soundness violations or to some other areas.

Table 12.6
FDIC Formal Enforcement Actions by Type, 1980–1995

Type	Number	Description
8(a)	394	Termination of insurance
8(b)	1,485	Cease-and-desist order
8(c&b)	88	Temporary cease-and-desist order
8(e)	369	Removal and/or prohibition and/or suspension of individuals
8(a&t)	2	Temporary suspension of deposit insurance
8(g)	19	Suspension and/or prohibition of individuals based on criminal indictment
8(i)	2	Petition for enforcement of administrative order
ILSA*	13	Capital directive
PCA†	25	PCA directive
OA	1	Other formal action
Total	2,398	

Note: Formal actions for safety-and-soundness purposes only.

*International Lending Supervision Act.

†Prompt Corrective Action (see section below on FDICIA).

banks that were classified as 4- or 5-rated at some point during this period, 662 (23 percent) failed, while 2,164 (77 percent) either survived as independent banks, were purchased by bank holding companies, or merged into banks without FDIC assistance. Therefore, approximately three out of four FDIC problem banks recovered without cash assistance from the insurer.

Tables 12.8 and 12.9 show the number and percentages of FDIC problem banks that received some type of formal enforcement action during the period. The data indicate that 47 percent of the total FDIC problem bank population received some type of formal enforcement action over this period. When displayed by CAMEL rating, 71 percent of 5-rated banks and 45 percent of 4-rated institutions received formal actions. Of the failed problem banks, approximately 71 percent received a formal FDIC enforcement action; of the surviving problem banks, approximately 40 percent did also (table 12.9). These data show that the enforcement policy of the FDIC was most aggressive with respect to the most unhealthy institutions—those that failed.⁴⁸

⁴⁸ Because data on FDIC-issued informal enforcement actions were not available before 1992, it was not possible to trace this record during the early stages of the problem-bank cycle. To verify the presence of informal actions for troubled banks, a set of randomly selected files, available for the years 1986 to 1994, on FDIC problem banks was reviewed. Of the 307 bank files that were examined, 292, or more than 95 percent of the banks, had received some type of formal or informal action. Only 15 of the 307 banks had no action on record. Thus, the data show that almost all problem banks received some type of enforcement action.

Table 12.7
FDIC-Supervised Problem Banks, 1980–1994
(Number)

Year of First 4 or 5 Camel Rating	All Problem Banks	Failed Problem Banks	Surviving Problem Banks		
			Independent Status	Acquired or Merged*	Total
1980	75	24	11	40	51
1981	96	30	14	52	66
1982	213	71	35	107	142
1983	242	54	51	137	188
1984	300	88	72	140	212
1985	423	117	132	174	306
1986	399	98	146	155	301
1987	263	64	83	116	199
1988	179	31	76	72	148
1989	151	32	66	53	119
1990	158	34	62	62	124
1991	178	14	96	68	164
1992	92	4	56	32	88
1993	33	1	23	9	32
1994	24	0	17	7	24
Total	2,826	662	940	1,224	2,164

*Acquired by a bank holding company or merged with another banking organization.

Federal Reserve Formal Enforcement Actions. The number of formal enforcement actions issued by the Federal Reserve System for safety-and-soundness purposes only against state member banks for the years 1980–95 is shown in table 12.10.⁴⁹ The number is broken out by CAMEL rating for the years 1980–95. The data show that the number of actions issued rose in the early 1980s as the number of problem banks increased, and reached a peak (47) in 1985. The number of actions fluctuated at lower levels until the early 1990s, when the total again increased, this time in response to the Northeast banking crisis. (The FDIC enforcement action program showed a similar temporal pattern.) Most Federal Reserve actions were brought against 4-rated banks, which accounted for over half of the

⁴⁹ Formal enforcement actions brought by the Federal Reserve against state member banks for violations of consumer laws and regulations, trust, EDP and other non-safety and soundness categories are excluded from the analysis. Also excluded are formal actions brought against bank holding companies, uninsured foreign banks, and those banks with missing examination records or other information.

Table 12.8
FDIC Problem Banks That Received Formal Enforcement Actions, 1980-1994
(Number)

Year of First 4 or 5 Camel Rating	All Problems Banks			Failed Problem Banks			Surviving Problem Banks		
	CAMEL Rating 4	CAMEL Rating 5	Total	CAMEL Rating 4	CAMEL Rating 5	Total	Independent Status	Acquired or Merged*	Total
1980	42	3	45	16	2	18	19	8	27
1981	52	5	57	19	2	21	21	15	36
1982	139	16	155	48	11	59	64	32	96
1983	116	19	135	36	11	47	50	38	88
1984	133	19	152	49	13	62	67	23	90
1985	157	21	178	63	16	79	76	23	99
1986	111	23	134	44	18	62	51	21	72
1987	70	14	84	20	10	30	38	16	54
1988	66	9	75	17	6	23	31	21	52
1989	59	4	63	21	2	23	29	11	40
1990	55	15	70	16	12	28	27	15	42
1991	81	10	91	3	7	10	65	16	81
1992	54	3	57	3	1	4	40	13	53
1993	13	4	17	0	1	1	12	4	16
1994	11	0	11	0	0	0	8	3	11
Total	1,159	165	1,324	355	112	467	598	259	857

*Acquired by a bank holding company or merged with another banking organization.

Table 12.9
Percentage of FDIC Problem Banks That Received Formal Enforcement Actions,
by CAMEL Rating, 1980–1994

Camel Rating	Failed Problem Banks	Surviving Problem Banks	Total Problem Banks
4	70%	39%	45%
5	73	66	71
4 + 5	71%	40%	47%

actions. However, 3-rated banks accounted for a higher percentage of actions (18 percent) than did 5-rated institutions (14 percent).

A breakdown of the types of formal actions issued by the Federal Reserve is shown in table 12.11. “Written agreements” is the category that accounted for the majority of the actions, with 203 (56 percent of the total). Cease-and-desist orders made up an additional 25

Table 12.10
Federal Reserve Formal Enforcement Actions by Examination Rating, 1980–1995
(Number)

Year	Number	CAMEL Rating at Examination before Enforcement Action				
		1	2	3	4	5
1980	7	0	0	2	5	0
1981	17	0	1	3	13	0
1982	18	1	3	3	8	3
1983	20	0	1	1	12	6
1984	23	0	1	3	13	6
1985	47	1	6	9	25	6
1986	43	0	1	7	27	8
1987	13	1	0	1	9	2
1988	25	0	3	4	12	6
1989	17	2	1	2	7	5
1990	26	0	2	8	14	2
1991	18	0	1	4	12	1
1992	40	2	8	6	22	2
1993	18	1	2	2	11	2
1994	19	1	1	8	8	1
1995	11	4	2	1	4	0
Total	362	13	33	64	202	50

Source: FRB.

Note: Formal enforcement actions for safety-and-soundness purposes only.

Table 12.11
Federal Reserve Formal Enforcement Actions by Type, 1980–1995

Type	Number	Description
8(b)	90	Cease-and-desist order
8(c)	10	Temporary cease-and-desist order
8(e)	56	Removal and/or prohibition and/or suspension of individuals
PCA	3	PCA directive
WA	203	Written agreement
Total	362	

Source: FRB.

Note: For safety-and-soundness purposes only.

percent, and removal actions against problem bank officials accounted for another 15 percent. When the Federal Reserve assigns formal enforcement actions to correct management

practices, it starts by issuing “written agreements.” If these actions are ineffective in altering management practices, the process is ratcheted upward by the issuance of cease-and-desist orders.

The number of Federal Reserve-supervised problem banks from 1980 to 1994 that received a 4 or 5 CAMEL rating, and their resulting status as either failed or surviving, are presented in table 12.12. The total number is significantly smaller than (only approximately 13 percent of) the number of FDIC-supervised problem banks. These data show that of the 365 banks that received a 4 or 5 rating during this period, 104 (29 percent) failed, while 261 (72 percent) either survived as independent banks, were purchased by bank holding companies, or merged into banks without FDIC assistance. Therefore, almost three-fourths of the Federal Reserve problem banks recovered without cash assistance from the insurer—about the same percentage as for the FDIC. The number and proportions of problem banks that received formal enforcement actions during the period are presented in tables 12.13 and 12.14. The data show that 50 percent of the 365 problem banks received some type of formal action. In contrast to FDIC actions, 4-rated Federal Reserve-supervised institutions received formal actions at a higher rate (51 percent) than for 5-rated banks (39 percent). Therefore, the

Table 12.12
Federal Reserve–Supervised Problem Banks, 1980–1994
(Number)

Year of First 4 or 5 Camel Rating	All Problem Banks	Failed Problem Banks	Surviving Problem Banks		Total
			Independent Status	Acquired or Merged*	
1980	11	1	8	2	10
1981	12	5	3	4	7
1982	20	6	7	7	14
1983	23	7	9	7	16
1984	27	13	11	3	14
1985	50	18	25	7	32
1986	49	16	28	5	33
1987	40	16	22	2	24
1988	26	7	10	9	19
1989	19	4	12	3	15
1990	22	6	11	5	16
1991	42	4	31	7	38
1992	19	1	10	8	18
1993	2	0	1	1	1
1994	3	0	2	1	3
Total	365	104	190	71	261

*Acquired by a bank holding company or merged with another banking organization.

Table 12.13
Federal Reserve–Supervised Problem Banks That Received
Formal Enforcement Actions, 1980–1994
(Number)

Year of First 4 or 5 Camel Rating	All Problem Banks	Failed Problem Banks	Surviving Problem Banks		Total
			Independent Status	Acquired or Merged*	
1980	7	1	5	1	6
1981	8	4	1	3	4
1982	11	4	4	3	7
1983	15	4	7	4	11
1984	19	10	7	2	9
1985	28	11	11	6	17
1986	17	11	5	1	6
1987	14	7	6	1	7
1988	12	2	5	5	10
1989	6	3	3	0	3
1990	8	2	4	2	6
1991	20	4	12	4	16
1992	15	1	9	5	14
1993	1	0	1	0	1
1994	2	0	1	1	2
Total	183	64	81	38	119

Source: FRB.

Table 12.14
Percentage of Federal Reserve–Supervised Problem Banks That Received
Formal Enforcement Actions, by CAMEL Rating, 1980–1994

Camel Rating	Failed Problem Banks	Surviving Problem Banks	Total Problem Banks
4	68%	46%	51%
5	35	46	39
4 + 5	62%	46%	50

highest percentage of actions were brought against 4-rated institutions, or those that had a fair chance of surviving; the remainder were applied against 5-rated banks, or those in more imminent danger of failing. Of the failed problem banks, approximately 62 percent were issued a formal action; of the surviving problem banks, 46 percent received one.

Formal Enforcement Actions: Relation to Risk-Taking Behavior

Above, the behavior of all problem banks (for the period 1980–94) is analyzed in relation to the dates of the banks’ failure, recovery, or merger. In this analysis, problem-bank behavior is analyzed in relation to the dates of regulatory intervention, specifically, the dates of the on-site examinations that produced CAMEL ratings either with or without formal actions. To perform this analysis, an event study was undertaken to analyze the ex ante and ex post behavioral patterns of these institutions. The hypothesis to be tested was that formal corrective actions are more effective in bringing about behavioral changes than are informal actions because informal agreements outstanding are not administratively or judicially enforceable in court, whereas formal actions have legal standing, and noncompliance often carries serious penalties. The variables examined were the same as in the earlier analysis: asset growth, dividend restrictions, and capital injections.⁵⁰

The event date chosen for the analysis was the date of the on-site examination that led to the formal enforcement action.⁵¹ To analyze the effect of enforcement actions, two sets of banks were observed: (1) those banks subsequently issued formal actions; and (2) those banks that did not receive a formal action.⁵² The population of banks was the combined sample of 2,826 FDIC and 365 Federal Reserve problem banks. Over the period 1980–95, the FDIC issued 2,398 formal actions, and the Federal Reserve issued 362. For the asset growth variable, the data were collected for four quarterly periods before and four after the event date. But because many firms do not report dividend payouts and capital contributions on a quarterly basis, these two variables were analyzed on an annual basis (for which all banks report data) for one year before and four years after the event date. To determine the stability of the relationship between regulatory intervention and changes in bank behavior over time, three different subperiods were analyzed: 1979–85, 1985–90, and 1990–95. The boundaries of the subperiods correspond with the various regional banking crises that occurred over the period under review.

For the asset growth variable, the results for the two groups are presented in figure 12.7. The median quarterly asset growth rates of banks supervised by the FDIC and the Federal Reserve with CAMEL ratings of 4 declined before the date of regulatory interven-

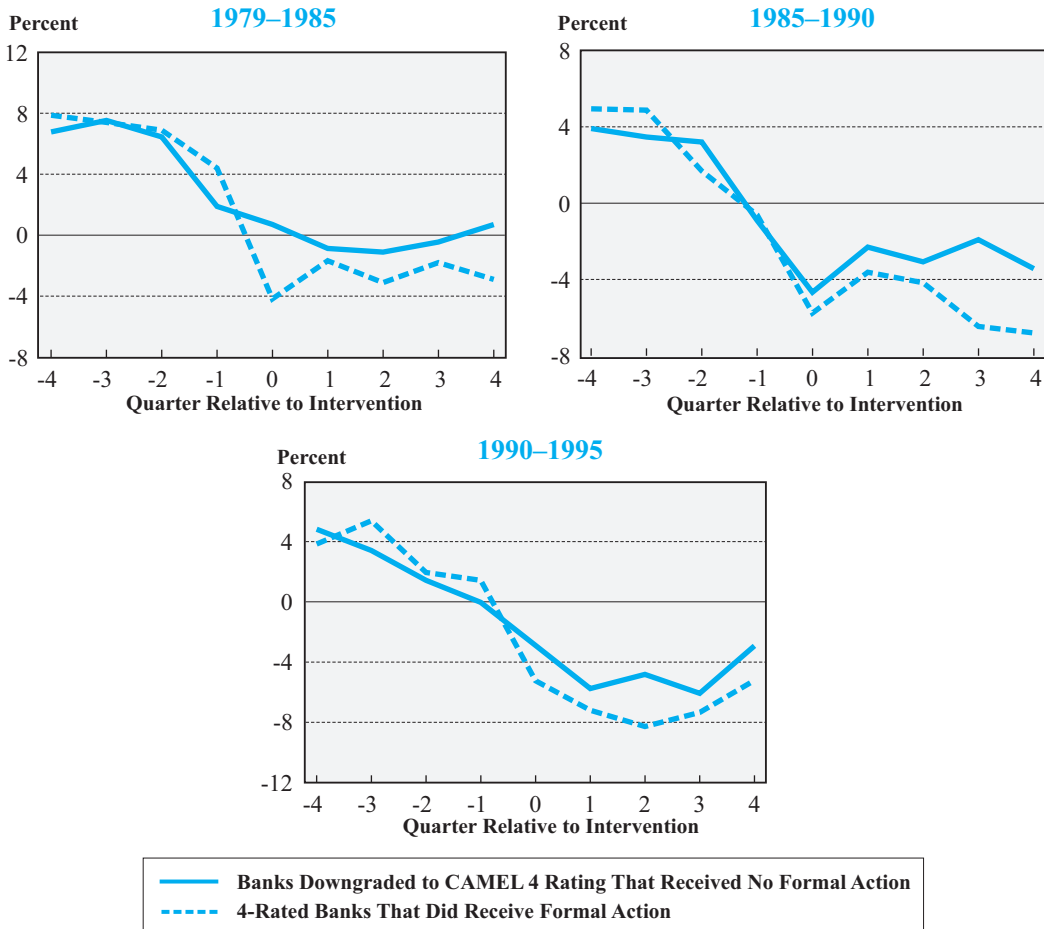
⁵⁰ Some studies have found that formal enforcement actions were effective in altering bank behavior. See Peek and Rosengren, “Bank Regulatory Agreements”; and U.S. General Accounting Office, “*Bank Supervision*,” 6–10.

⁵¹ The “event date” was not the date when the bank actually received the enforcement action; rather, it was the date of the examination that led to the decision to issue a formal action. The reason for choosing the earlier date as the “event date” is that remedial changes in bank behavior are expected to start at least at the earlier time, if not before (in anticipation of the action). The legal document itself is not presented to the problem institution until the paperwork is completed, generally at least six to nine months after the examination.

⁵² As previously indicated, although some problem banks may not have been presented with a formal enforcement action, at the time of their rating as a problem bank most of them had an informal action already in place.

Figure 12.7

Median Asset Growth Rates of CAMEL 4-Rated Banks before and after Regulatory Intervention (Annualized)



Note: Data are median asset growth rates of FDIC- and Federal Reserve-supervised banks before and after regulatory intervention. For this analysis, the intervention dates were dates of

- (1) examinations that resulted in the downgrading of the bank's CAMEL rating to 4 but did not result in a formal enforcement action, or
- (2) the last examination before the issuance of a formal enforcement action against a bank with a CAMEL 4 rating.

Normally, a bank is informed at the time of the examination of the prospect of a CAMEL rating downgrade or a formal enforcement action. Data were run on a constant population sample for each period. The number of observations ranged from 200 to almost 500 for the different periods for banks downgraded to CAMEL 4 rating that did not receive formal enforcement actions, and from 200 to 300 for 4-rated banks that did receive formal enforcement actions.

tion and generally remained negative in the quarters immediately following the intervention.⁵³ This was true both for banks that did and for banks that did not receive formal actions. Banks with formal actions showed more pronounced changes in growth rates, on average, from before to after intervention than banks without such actions. Other measures revealed similar results (see figure 12.8). Dividend rate reductions and increases in external capital infusions began before regulatory intervention and generally accelerated in the first year after intervention; banks subject to formal enforcement action showed the largest dividend cuts and capital infusions. The data for loan-loss provisions (not presented here) revealed comparable results.

The analysis indicates that bank management was taking remedial actions before the examinations that triggered reductions in CAMEL ratings and (possibly) formal enforcement actions. It is not known whether these remedial actions were a response to market forces, management's own analysis, or anticipated regulatory action, but in any event, regulatory intervention apparently had the effect of reinforcing and accelerating these remedial actions. Changes in the behavior of problem banks were greatest for banks subject to formal enforcement actions, but it is not clear whether the differences associated with formal enforcement actions were primarily due to the more stringent nature of such actions or to the relatively poorer condition of those banks that received them.

In general, the reduction in asset growth indicates that moral hazard was being contained—that troubled banks were not attempting, or were not allowed, to “grow out of their problems”; indeed, in most cases the assets were shrinking. In the case of the surviving banks, reduced dividend payouts and increased capital injections helped restore equity positions and were instrumental in facilitating recovery. In the case of the failing banks, dividend cuts and new capital had the direct effect of reducing the costs of failure. Again, whether these favorable results were due to the actions of management, stockholders, market forces, or supervisors, they were consistent with the objectives of preventing the failure of troubled banks and reducing costs to the insurer for banks that did fail.

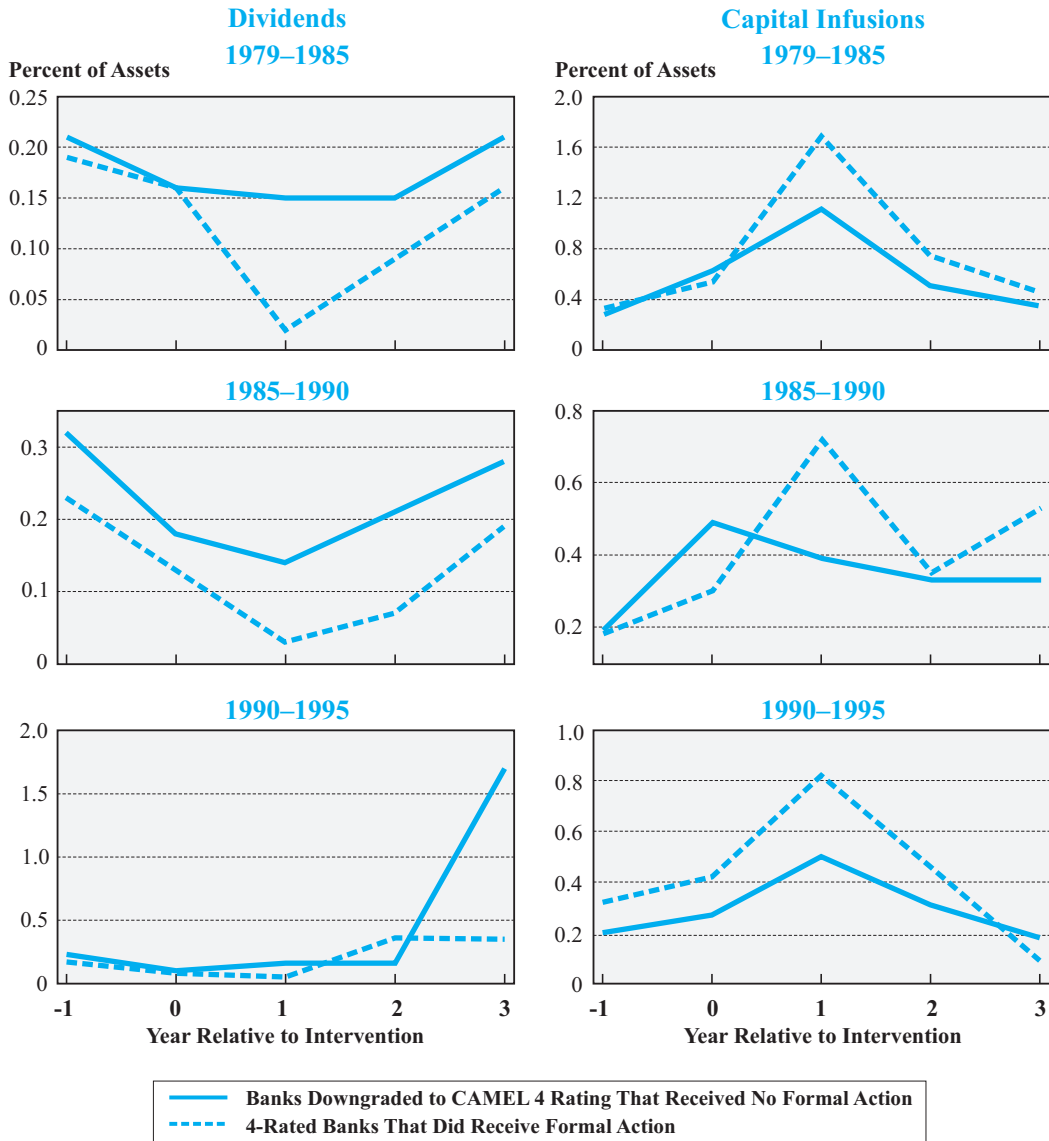
FDICIA and Prompt Corrective Action

Congress passed FDICIA in 1991 to correct what it perceived as the banking agencies' regulatory forbearance toward undercapitalized banks during the 1980s.⁵⁴ FDICIA was designed to limit regulatory forbearance by requiring (1) a more timely closure of failing institutions and (2) earlier intervention in problem banks. These provisions are referred

⁵³ The analysis was also run for 3- and 5-rated banks but, because of the limited sample size of the observations, the data are not presented here. The results for the 3-rated banks showed no significant and consistent results between the assignment of formal actions and changes in behavior. The results for the 5-rated banks were consistent with the overall findings for the 4-rated institutions.

⁵⁴ However, during the 1980s Congress itself had mandated several statutory forbearance programs for financial institutions, including the Net Worth Certificate Program for thrift institutions and the loan-loss amortization for agricultural banks.

Figure 12.8
Dividend Rates and Capital Infusions of CAMEL 4-Rated Banks
before and after Regulatory Intervention



Note: Data are averages of individual bank ratios. See note to figure 12.7.

to as “prompt corrective action” (PCA).⁵⁵ PCA specifically mandated certain rules the banking agencies had to follow with respect to the supervision of undercapitalized banks.⁵⁶ As an institution’s capital position declines, the appropriate federal regulator is required to take increasingly stringent actions; for “undercapitalized” institutions, these include establishing a capital restoration plan and restricting deposit taking, asset growth, dividends, and management fees; for banks that are “critically undercapitalized” for a prescribed period, this includes closing the bank.

The question arises how FDICIA and PCA might have affected problem banks during the 1980s if the law had been in effect then. Would PCA provisions have reduced losses to the bank insurance fund between 1980 and 1992 by requiring earlier closure of some banks? Conversely, would other banks that did not fail have been closed unnecessarily, with increased losses to the fund?

It is difficult to reach any conclusion about what would have happened if PCA had been in effect during the 1980s, because both banks and bank regulators would have been responding to a different statutory and regulatory regime. Thus, the analysis presented here to quantify the effects of PCA is only an approximation.

Timely Closure

Concerning timely closure, it is unclear what impact FDICIA would have had on undercapitalized banks during the period 1980–92. PCA requires that banks be closed when their tangible capital ratio reaches 2 percent for a specified period.⁵⁷ Had this provision been in effect during the 1980s, some banks that failed might have been closed earlier, but it is also possible that some banks that did not fail might have been closed unnecessarily. During the period 1980–92, most banks that failed were closed within the time frame specified by FDICIA for critically undercapitalized banks. However, 343 banks (approximately 21 percent of all failures) with \$88 billion in total assets might have been closed earlier, presumably resulting in reduced losses to the insurance fund (see table 12.15). The table also

⁵⁵ The Prompt Corrective Action provisions of FDICIA did not become effective until one year after passage of the act, or about year-end 1992.

⁵⁶ FDICIA mandated five capital categories: “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized.” For banks in the last three categories, supervisors are required to impose a ladder of constraints on their operations.

⁵⁷ Under FDICIA, when an institution is critically undercapitalized for 90 days a receiver or conservator must be appointed or some other action must be taken to achieve the purpose of the provision. The 90-day delay may be extended, provided that the regulator and the FDIC concur and document why extension would better serve the purposes of the provision. After the institution has been critically undercapitalized for 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. Under the conditions existing in the 1980s when failures were bunched and the market for failed institutions was often saturated, it seems reasonable to suppose that taking more than 90 days to spread out marketing efforts for failed banks would have been an acceptable reason for delay up to the 270-day limit.

Table 12.15
Estimated Number of Failed Banks That Would Have Been Closed Earlier
under FDICIA Rules, 1980–1992

Year	Number of Banks	Average Number of Days*	Average Number of Days (Weighted)†	Total Assets (\$Millions)
1984	1	16	16	\$ 9.6
1985	2	180	169	182.9
1986	16	99	96	1,111.4
1987	49	127	168	1,857.1
1988	69	144	173	9,095.8
1989	78	164	271	13,497.3
1990	63	252	334	5,561.2
1991	39	172	257	36,565.1
1992	26	238	507	19,946.4
Total	343	174	308‡	87,826.7

Note: Before 1984 no banks would have been closed earlier under FDICIA. The PCA provisions of FDICIA became effective in December 1992 so the following years are not included.

* Number of days beyond the 270 allowed before bank would have had to be closed under FDICIA.

† Days are weighted by total assets. Total assets are as of PCA failure date.

‡ This figure is not a total; rather, it is the average number of days for the 343 banks.

shows the average number of days that the banks remained open beyond the PCA mandate. For the group as a whole, the number averaged 174 days on an unweighted basis and 308 days when the number of days is weighted for bank size, a differential suggesting that size was a factor in the closing decisions. When this group is broken out by bank charter class, the data show that 201 of the 343 banks (59 percent) were national banks, 131 (38 percent) were state nonmember banks, and 11 (3 percent) were state member institutions (see table 12.16).

The closing of depository institutions is the shared responsibility of both federal and state banking authorities. The OCC has the responsibility for closing national banks, and the state banking departments for closing state-chartered institutions. Because the chartering authority and not the insurer has authority to declare insolvency, the various agencies may have different incentives leading them to pursue different closure strategies. The insurer will usually want earlier action, but the chartering agency may have practical reasons to delay closing. These reasons may include the effect on the local economy or some feeling of allegiance to a bank the agency itself chartered. Charterers also are seen as having some in-

Table 12.16
Estimated Number of Failed Banks That Would Have Been Closed Earlier under
FDICIA Rules, by Bank Charter Class, 1980–1992

Year	National		State Nonmember		State Member	
	Number of Banks	Average Number of Days	Number of Banks	Average Number of Days	Number of Banks	Average Number of Days
1984	1	16	0	0	0	0
1985	1	204	1	156	0	0
1986	9	83	6	123	1	94
1987	25	155	24	98	0	0
1988	40	154	23	148	6	64
1989	56	164	19	181	3	75
1990	49	252	13	252	1	267
1991	13	241	26	138	0	0
1992	7	181	19	259	0	0
Total	201	184*	131	167*	11	88*

Note: Refer to footnotes for table 12.15.

*This figure is not a total; rather it is the average number of days for the 201 banks.

terest in promoting their own segment of the banking industry. Meanwhile, the insurer assumes any additional costs associated with a delayed closing.

Data for the banks whose closings were delayed beyond the PCA limit are broken down for the six states that had the most closings overall and the most late closings (see table 12.17). Of the 343 banks nationwide whose closings were delayed, 256 were located within these six states. The data show that state banking authorities in the six states generally closed problem banks in a more timely fashion than did the OCC. Of the total 473 national banks closed in the six states during the years 1980–92, the OCC closed 178 (38 percent) later than would have been required under the PCA mandate. Conversely, regulators in the six most active states closed 459 banks, only 78 of which (17 percent) would have violated the PCA requirement. These differences were especially apparent in the southwestern states of Texas and Oklahoma, which accounted for more than 75 percent of all failures over the period. In these two states, national banks were closed late 38 percent of the time, whereas the comparable figure for state banks was less than 16 percent. The timely closing pattern was observed in all six states except Louisiana, where 38 percent of the 58 banks were closed later than would have been called for by the PCA rule—yet even there the state had a better record than the OCC, which was late in the case of more than half of the national banks closed.

Table 12.17

Estimated Number of Failed Banks That Would Have Been Closed Earlier under FDICIA Rules in the Six States with the Greatest Number of Closings, 1980–1992 (by Closing Authority)

State	OCC					State				
	PCA Required Earlier Closure	Total OCC Failures (Number)	Late Closing (Percent)	Average Closing (Days)	Total Assets (\$Millions)	PCA Required Earlier Closure	Total State Failures (Number)	Late Closing (Percent)	Average Closing (Days)	Total Assets (\$Millions)
Texas	136	359	37.9	185	\$24,418	41	230	17.8	134	\$ 2,811
Oklahoma	20	51	39.2	203	626	7	71	9.9	137	333
Louisiana	7	12	53.3	139	136	22	58	37.9	216	1,614
Colorado	7	25	28.0	107	95	0	33	0.0	0	0
New York	4	9	44.4	392	826	4	24	16.7	771	20,525
California	4	17	23.5	104	100	4	43	9.3	63	262
Total	178	473	37.6	185*	\$26,201	78	459	17.0	186*	\$25,545

Note: Refer to footnotes for table 12.15.

*This is not a total; rather it represents the average number of days for the 178 banks.

Part of the reason for the OCC's comparatively greater delay may be the bank closure rules adopted by the respective closing authorities. Up through mid-December 1989, OCC rules prohibited the closing of a national bank until all "primary capital" was exhausted (the regulatory-insolvency rule). This was based on a statutory requirement that a national bank be closed if the Comptroller was satisfied that the bank was insolvent and the OCC's own definition of insolvency. "Primary capital" was defined to include both total equity capital and loan-loss reserves. Most individual states were not constrained by the same set of rules. The six states where most of the bank failures occurred during this period had the authority to close banks when capital was "impaired" or when the bank either faced "imminent insolvency" or was in an "unsafe" or "unsound" condition. These more flexible standards made it possible for the states to close banks earlier.⁵⁸ However, although the OCC's closing policy was constrained by a statutory insolvency requirement, the agency had wide latitude to define insolvency and could have adopted a more flexible standard than it did during most of the 1980s. In December 1989, after about a year of study, the OCC changed the historical closure rules by adopting an equity capital-only rule, excluding reserves, which allowed for

⁵⁸ Information on the statutory authority of the six state banking departments is based on conversations with representatives of each of the six departments.

more timely closures.⁵⁹ But by the time this change was made, most of the failures of the 1980s had already been resolved.⁶⁰

To estimate the cost of delaying the closure of the 343 undercapitalized institutions that might have been closed earlier, FDIC researchers analyzed changes in total equity capital between the date of the PCA-required closing and the date of actual failure (see table 12.18). The results show that the 343 banks had total equity capital of approximately \$220 million at the PCA-required closing date and approximately a negative \$1.6 billion at the actual closing date. However, a large part of these losses were not accrued over the six-month average holding period, because a substantial percentage were already embedded within bank portfolios at the PCA failure date, although not yet recognized. Operating losses might still have been incurred, however, because of the higher private sector funding

Table 12.18
Changes in Total Equity Capital for Failed Banks That Would Have
Been Closed Earlier under FDICIA Rules, 1980–1992

Year	Number of Banks	Equity Capital at PCA Failure Date (\$Thousands)	Equity Capital at Actual Failure Date (\$Thousands)
1984	1	\$ -140	\$ -161
1985	2	-543	-6,032
1986	16	12,299	46,501
1987	49	-56,944	-136,232
1988	69	-189,748	-256,323
1989	78	-73,577	-693,064
1990	63	-64,654	-359,590
1991	39	21,184	-539,336
1992	26	571,826	358,068
Total	343	\$219,703	\$ -1,586,169

Note: Refer to footnotes for table 12.15 where applicable.

⁵⁹ OCC, *Bulletin BB-89-39*, December 13, 1989.

⁶⁰ Edward J. Kane argues that bank supervisors have incentives to forbear from prompt closure of insured banks because bank failures and insurance losses make it appear that supervisors are not effectively discharging their responsibilities of oversight. He claims that this was one of the prime motives for the forbearance granted to insolvent thrift institutions during the 1980s (*The S&L Insurance Mess: How Did It Happen?* [1988], chap. 4).

costs and the cost of operating retail branch systems.⁶¹ These costs that would have been saved (estimated to be approximately \$825 million) are approximately 8 percent of the total resolution costs of the 343 banks and approximately 2 percent of the cost of all bank failures during the period 1980–92. Approximately 60 percent of the estimated cost savings are attributable to six large banks that operated with less than 2 percent tangible capital for relatively long periods of time.

An alternative estimate of the avoidable cost, based on net operating losses, produced essentially the same aggregate result. Net operating losses before loan-loss provisions, gains/losses on transactions, taxes, and extraordinary items totaled \$815 million for the 343 banks for the intervals between closure dates required by PCA and actual closure dates. As in the previous estimate, these losses were concentrated in a few large banks.

Some caveats should be mentioned with respect to these estimates. Regulators' bank closure policies would have been different if PCA had been in effect in the 1980s, and such policy changes might have reduced projected cost savings. For example, for the many banks that were allowed to operate with tangible capital below 2 percent for only a few months beyond the interval allowed by PCA, earlier closure might have meant insufficient time to market the institution among potential acquirers and therefore the resolving of more banks through insured-deposit payoffs.⁶² This outcome would have been likely in periods when failures were proliferating and the market for failed bank and thrift deposit franchises and assets was temporarily saturated. Spreading closures over a longer period of time might have attracted improved bids and offset some of the additional costs resulting from delayed closings. Therefore, the savings resulting from the earlier implementation of PCA might have been smaller for many of the 343 banks than these estimates suggest. For the 6 large banks that operated for extended periods of time with low capital levels, earlier closure would probably have achieved cost savings, although for some of these banks lengthy marketing periods might have been needed, which might have reduced the amount of the savings. Presumably, because of PCA, regulators might have had to start the marketing process earlier, while the banks had capital well above the 2 percent level.

⁶¹ The avoidable cost is estimated as the sum of (1) the actual funding costs of these banks minus the one-year Treasury rate and (2) the operating expenses of transactions and nontransactions deposit accounts as estimated by the 1990 Functional Cost Analysis of the Federal Reserve Board. The avoidable cost was computed for the period of time beyond 270 days that the bank's tangible capital ratio was below 2 percent. In cases where the tangible capital ratio fluctuated below and above 2 percent, the bank was considered to be critically undercapitalized for the entire period after the ratio first fell below 2 percent, except when the ratio subsequently rose above 3 percent. In the latter case, that bank was counted as critically undercapitalized only for the period it was below 2 percent subsequent to having reached the 3 percent level. Two large savings banks that had entered into Income Maintenance Agreements with the FDIC in connection with the acquisition of other failed institutions were counted as critically undercapitalized from the time the bank's agreement was terminated (in one case) and (in the other case) from the date the FDIC formally permitted the bank to miss capital targets prescribed in its agreement.

⁶² Gilbert makes this point in volume 2 of this study.

Conversely, the 2 percent tangible equity capital rule might have forced the possibility of unnecessary closure on 143 problem banks (those rated CAMEL 4 or 5), with \$11 billion in total assets, that did not fail. The result might have been increased cost to the deposit insurance fund (see table 12.19).⁶³ The data show that at the time when FDICIA might have mandated their closure, the 143 banks had total assets of \$10.9 billion and \$64 million in equity capital. What it might have cost the insurer to resolve these cases is unknown. And in addition to payoff costs by the insurer, there would have been social or deadweight costs that the public and the local communities would have had to absorb upon the unnecessary closing of local institutions.

The assumptions underlying the forbearance programs that Congress mandated during the 1980s differed from those underlying the later PCA provisions of FDICIA. Thus, banks in those forbearance programs were excluded from the computations that produced the estimates that 343 failing banks would have been closed earlier and that 143 banks might have been unnecessarily closed if PCA had been applied in the 1980s. Nevertheless, to complete the record, a similar methodology was used for banks that participated in these forbearance programs. The results show that 48 banks that actually failed, with \$11 billion

Table 12.19
Estimated Number of Problem Banks That Survived but
Might Have Been Closed under FDICIA Rules, 1980–1992

Year	Number of Banks	Total Assets (\$Millions)	Total Equity (\$Thousands)
1982	1	\$ 8.4	\$ -24
1983	1	33.8	256
1984	7	366.8	18,255
1985	9	363.6	13,784
1986	14	844.2	11,455
1987	19	378.1	6,311
1988	26	2,974.4	88,358
1989	16	2,892.8	46,912
1990	15	1,305.0	-18,573
1991	25	1,160.0	-107,041
1992	10	602.0	3,933
Total	143	\$10,929.1	\$ 63,626

Note: Refer to footnotes on table 12.15 where applicable.

⁶³ A large percentage of these banks were able to raise capital within 12 months of the PCA failure date; thus, many of these banks would probably have been recapitalized rather than closed.

in assets, would have been closed earlier as a result of PCA, and 66 banks that actually survived, with \$16 billion in assets, would have been closed.

Early Intervention

Recent empirical studies of banking show that in most cases, PCA's early-intervention provisions would not have required bank supervisors either to impose more severe restrictions on banks or to intervene earlier. In fact, supervisors had identified most problem banks and had some enforcement actions in place at significantly earlier stages than might have been required under the PCA provisions.⁶⁴ Moreover, the restrictions the regulators imposed were more comprehensive than those prescribed in the PCA legislation.⁶⁵ The reason behind this finding is that capital ratios prescribed in PCA are lagging indicators of the health of the institution and would trigger enforcement actions well after problems had been identified in examinations. Examiners evaluate considerably more information than capital ratios to determine the bank's likelihood of failure.

These findings are supported by an analysis of FDIC-supervised problem banks, some of which failed and some of which survived. Of the 127 banks that might have been closed earlier, 101 (approximately 80 percent) had received enforcement actions to control or limit risk-taking behaviors before PCA closure would have been required.⁶⁶ On average, these enforcement actions were brought 419 days before the mandated PCA failure date and 570 days before actual failure (see table 12.20).

For problem banks that survived but might have been closed by PCA provisions, 33 of the 58 banks (57 percent) received a formal enforcement action (see table 12.21). The average number of days that enforcement actions were brought before PCA failure was 550. The data also show that 16 banks (28 percent) received no formal action, and another 9 banks received a formal action after the required PCA closure; these data suggest that something may have been lacking in the enforcement process.

⁶⁴ See Gilbert, "Legislating Prompt Corrective Action."

⁶⁵ Recent studies show that bank supervisors generally intervened with problem banks at much earlier stages, initiating more formal enforcement actions during the 1980s and early 1990s than would have been required by PCA legislation, and these actions were more stringent than those PCA would have imposed. This was especially true with respect to the New England banking crisis of the early 1990s. See two articles by Peek and Rosengren: "Will Legislated Early Intervention Prevent the Next Banking Crisis?" Federal Reserve Bank of Boston, Working Paper 96-5 (1996), and "The Use of Capital Ratios to Trigger Intervention in Problem Banks: Too Little, Too Late," Federal Reserve Bank of Boston *New England Economic Review* (September/October 1996).

⁶⁶ Enforcement data were unavailable on four of the FDIC-supervised banks that would have been closed earlier under the FDICIA rules.

Table 12.20
Timing of FDIC Enforcement Actions against FDIC Problem Banks That Failed and Would Have Been Closed Earlier under FDICIA Rules, 1980–1992

FDIC Enforcement Action	Number of Banks	Enforcement Action before FDICIA Failure Date (Average Days)	Enforcement Action before Actual Failure Date (Average Days)	Between FDICIA Failure Date and Actual Failure Date (Average Days)
Formal	101	419	570	151
No Formal	16			84
Formal (after FDICIA Failure Date)	10	-48	187	235
Total	127			

Note: Formal enforcement actions for safety-and-soundness purposes only.

Table 12.21
Timing of FDIC Enforcement Actions against FDIC Problem Banks That Survived but Might Have Been Closed under FDICIA Rules, 1980–1992

FDIC Enforcement Action	Number of Banks	Enforcement Action FDICIA Failure Date (Average Days)
Formal	33	550
No Formal	16	
Formal (after FDICIA Failure Date)	9	-244
Total	58	

Note: Formal enforcement actions for safety-and-soundness purposes only.

Conclusion

Several lessons can be drawn from this analysis about the bank supervisory system. First, hindsight shows that the public policy decisions to reduce examination resources in the early 1980s were a failure. Few could have anticipated the severity of the regional recessions or their attendant problems, but reducing examination staffs was a high-risk policy. Second, to identify risk early and ensure the integrity of bank financial reporting, frequent on-site examinations are necessary. Third, early detection of problem institutions increases the likelihood that supervisory monitoring and enforcement actions will be effective in stemming losses to the insurance fund. Fourth, the examination system needs to capture more risks systematically, including those posed by changes in local and regional economic conditions.

Appendix □

The Examination Process

Supervisory responsibilities for the nation's insured commercial banks are divided among the 3 federal banking agencies and the 50 state supervisory authorities. Of the federal banking agencies, the Office of the Comptroller of the Currency is responsible for supervising national banks; the Federal Reserve System is responsible for supervising both state member banks and holding companies; and the FDIC is responsible for supervising state nonmember banks and FDIC-insured savings banks. The FDIC also has back-up supervisory responsibility for monitoring the condition of national banks and state member banks, and in fulfilling these responsibilities it works with the other two federal regulatory agencies. Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), it also has back-up authority to examine thrift institutions as well. State banking departments supervise state-chartered banks.

Within the context of maintaining public confidence in the integrity of the banking system and protecting the insurance fund, bank examiners evaluate all aspects of a bank's operations. In particular, examiners analyze the overall financial condition of an institution; appraise the quality of its management, including its board of directors; determine its overall compliance with applicable laws and regulations; review the adequacy of its internal controls and procedures; identify areas where corrective action may be necessary; and establish a factual record to support recommendations for corrective actions. The examination consists of three major stages: off-site analysis and review, on-site examination, and preparation of a report that documents the results of the examination. When the examiners identify significant problems, there is a fourth stage: the use of informal or formal administrative corrective actions.

Chapter 13 discusses off-site analysis and review. The other three stages of the examination process are surveyed here. Also discussed here are cooperation between state and federal agencies in the examination process, and coordination among the federal agencies.

On-Site Examinations

An examination starts when the field office supervisor schedules an examination for a specific date and assigns an examiner-in-charge to supervise the job.⁶⁷ This examiner has full responsibility for supervision of the entire examination process. The examiner-in-charge is assisted by a junior commissioned examiner or assistant examiner, who oversees

⁶⁷ In the past, examinations were conducted on a surprise basis—especially for smaller-sized and problem banks. Institutions are now notified of pending examinations and allowed time to assemble requested information.

the financial analysis and operational portions of the review. The size and composition of the examination team depend on the scope of the examination and the size and complexity of the bank. The team is normally composed of assistant and commissioned examiners from a wide range of grade levels and with varied examination experience.

In anticipation, the examiner-in-charge reviews past examination reports, information on bank holding companies and chain banking relationships,⁶⁸ various off-site reviews, bank correspondence, and any other available information. Although pre-exam review and planning always existed during the 1980s, the process was not formalized. Recently, however, the federal agencies developed more formalized procedures, and current procedures require written pre-examination plans. To gather pre-exam information, regulators submit requests for various bank records and often use informal questionnaires before physically entering the bank. The FDIC also requires management to complete a formal questionnaire.

Generally the examination focuses on two broad areas: (1) the review of asset quality, and especially the loan portfolio, which generally constitutes the largest share of the bank's total assets; and (2) the financial analysis of the bank's condition, as well as a review of all other aspects of the bank's operation. The more experienced examiners generally focus on the loan portfolio, while the assistant and less-experienced examiners work on the financial analyses and the remaining operations work not associated with the loan portfolio.

The examiners conducting the loan-portfolio review first determine a loan cutoff, or the percentage of the loan portfolio that will be reviewed. The percentage of loans reviewed depends on a number of factors, including the bank's last composite CAMEL rating, trends in loan quality, and local economic conditions. Examiners normally analyze not only the loans identified by the cutoff but also the previously classified credits, non-performing loans, loans included on the bank's internal watch list, and insider loans. (When the OCC determines which loans will be reviewed by its examiners, it generally relies on statistical and judgmental sampling techniques. The FDIC uses sampling procedures in larger banks and in institutions with strong internal monitoring and quality review programs.) The examiner-in-charge has the option of expanding the volume of loans reviewed at any time, particularly in banks with deteriorating asset quality. In institutions with severe or deteriorating asset problems, examiners often review 70 percent or more of a bank's loan portfolio.

During the loan review, examiners make a judgment as to which credits are of poor quality or have deteriorated in quality and/or have more than the normal risk of repayment. These credits are flagged for further discussion with the loan officers and management. In

⁶⁸ "Chain banking relationships" refers to banks that are controlled by the same ownership group but are not associated with a bank holding company.

addition to the loan quality analyses, examiners review the loan portfolio for concentrations of credit, violations of legal lending limits, technical exceptions to the credit files, and loans made in contravention of the bank's internal loan and underwriting policies. Loans are then discussed with the loan officers and management and are classified on the basis of their overall quality and the examiner's perception of the risk of loss to the bank. The examiner will either "pass" a credit or assign it to one of the following categories: (1) special mention, (2) substandard, (3) doubtful, or (4) loss. Management is provided with a list of the adversely classified loans, of loans that are held in apparent violation of banking laws and regulations, and of concentrations of credit. In addition, management is provided with a list of those credits that have documentation exceptions (if the volume is significant).

The more-junior examiners, charged with completing the financial analysis and operational aspects of the examination, conduct nearly all the remaining aspects of the on-site review: they examine the other asset and liability accounts, capital and reserve adequacy, liquidity and interest-rate sensitivity, insider activities, subsidiary and affiliate information, litigation, contingent liabilities, and any off-balance-sheet activities.

The overall examination procedures are directed primarily toward the five performance categories used in the "Uniform Financial Institutions Rating System" (UFIRS), namely, Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity (CAMEL).⁶⁹ The examiners must address each of these areas and must include an assessment of each in the final report of examination (see box 1, below).

Once the on-site review is complete, the examiner-in-charge conducts an exit meeting at which the examination findings are fully discussed with the active officers of the bank. Management's and the bank's strengths are recognized, but the primary focus of the comments and recommendations is on those areas needing management's special attention. Emphasis is placed on providing management with a complete summary of the examination findings and obtaining a commitment from management to correct any deficiencies. Management is given an opportunity to discuss these findings and to agree or disagree with the results of the review.

The final step of the on-site examination is a meeting to which all members of the board are invited. The board meeting could be scheduled either during the on-site review or within a reasonable period of time after the examiners leave the bank. (The FDIC does not always require a board meeting but schedules one whenever a bank is, or probably will be, given a composite rating of 3, 4, or 5. In contrast, the OCC is required to conduct a final meeting with the board during or following the on-site review.) The results of the review are

⁶⁹ FDIC, *DOS Manual of Examination Policies*, pp. 1.1-1 to 1.1-4; and Policy Statement on Uniform Financial Institutions Rating System (UFIRS), *Federal Register* 62 (January 6, 1997), 752. Use of UFIRS began in 1979.

discussed with individual board members, who are given the opportunity to express their views and opinions. In these meetings the emphasis is on getting a commitment from the board members, individually and as a group, to take strengthening or corrective actions where necessary. Management weaknesses and strengths are also discussed. If the results of the review are such that the condition of the bank has deteriorated enough to become a problem, the likelihood of informal and/or formal corrective action is also discussed. In cases in which the bank is, or is likely to be, rated a composite 4 or 5, the regional or district office would send a representative to the meeting with the board.

The examiner is required to disclose the bank's composite rating to the bank's board of directors. (For the definition of each of the five CAMEL composite ratings, see box 2, below.) Historically the five component CAMEL ratings were used internally by the regulators and were not disclosed to management or the bank's board. Since January 1997, however, under revised examination procedures worked out by all federal bank regulatory agencies, component CAMEL ratings have been released to officials of the bank. The ratings are confidential and are available only to bank officials and the regulators.

Preparation of the Examination Report

A written report is prepared in conjunction with every on-site examination and is subsequently sent to the bank's board of directors for review. The report makes a factual presentation of the institution's overall condition and is organized in accordance with the components of the CAMEL rating system: capital adequacy, asset quality, management, earnings, and liquidity. It also summarizes the scope of the examination; references the meetings held with management and the board, including the topics discussed and any of management's actions, commitments, and responses; and makes recommendations for improving the areas containing deficiencies and other weaknesses. The report should enable bank directors to identify areas in which they are not fulfilling their duties and should encourage them to discharge properly their responsibilities for operating the bank in a safe and sound manner.

Before the final report is forwarded to the bank, the report plus recommendations for any informal or formal enforcement action are transmitted to the FDIC regional office for review. (The OCC has delegated much of its review process to the field level, with the district office involved in reviewing only 3-, 4-, or 5-rated banks or banks subject to various enforcement actions.) The examiner-in-charge works closely with various staff members of the regional or district office, especially when examining a deteriorating or problem bank, keeping the staff members informed of any unusual activities or findings. A transmittal letter and the report of examination are then forwarded to the bank's board for final action. Any additional supervision and follow-up are generally handled by the various regulatory regional or district office staffs.

Use of Formal and Informal Enforcement Actions

A number of formal and informal administrative corrective actions are available to the federal bank regulatory agencies. The primary corrective tools of all the regulatory agencies are the use of reason and moral persuasion during the on-site examination, management meetings, and final board review; the commentary and recommendations in the report of examination; and communications from the regional and Washington offices. Informal corrective procedures consist of the use of memorandums of understanding (MOU) and the bank's adoption of a board resolution. Under Section 8 of the FDI Act as amended in 1966, the FDIC Board of Directors was given broad formal enforcement powers (cease-and-desist and removal authority), and FDICIA mandated the use of Prompt Corrective Action. Finally, the federal regulatory agencies have the authority to impose civil money penalties in certain cases. Although the three regulatory agencies may vary in this respect, formal or informal administrative actions are generally taken on banks whose composite uniform ratings are 3, 4, or 5, unless specific circumstances warrant otherwise. (For a description of the types of enforcement actions, see box 3, below.)

Federal-State Cooperation

In the early 1970s, all state-chartered banks were examined annually by both state and federal agencies. In 1974, the FDIC started an experimental program in three states to determine the feasibility of using state examinations in alternate years for nonproblem banks.⁷⁰ Three years later, it made its first agreement with a state—with Georgia.⁷¹ By 1980 it had examination agreements with 14 states, and during the decade the number grew.⁷²

To qualify for the program, a state is required to have sufficient examination resources and capabilities to complete the task satisfactorily. Problem banks (4- and 5- rated) and banks of supervisory concern (3-rated) are not included in the program. The FDIC and state authorities coordinate their examination schedules to take advantage of their combined resources and to minimize duplication and burden on the institutions. In addition to alternating examinations, the FDIC allows state authorities access to computerized databases that provide Call Report information.⁷³ The FDIC also works closely with state authorities in issuing enforcement actions and in developing common application forms, to minimize duplicative filings.

⁷⁰ FDIC, *Annual Report* (1974), 10.

⁷¹ *Ibid.* (1977), 3.

⁷² *Ibid.* (1980), 5; and an address by FDIC Chairman L. William Seidman to the Conference of State Bank Supervisors, Washington, D.C., December 9, 1985.

⁷³ FDIC, *Annual Report* (1980), 5.

In 1981, the Federal Reserve also adopted a policy of alternating federal and state examinations for certain of the banks it supervised.⁷⁴

In addition to alternating examination cycles, state and federal agencies conduct concurrent and joint examinations, to reduce the supervisory burden on state banks. Joint examinations result in one examination report used by both agencies, while a concurrent examination usually yields two separate reports.

Federal Agency Coordination

The federal banking agencies began to coordinate their operations and policies in the mid-1970s. In 1976, they began their shared national credit program for all loans \$20 million or more that are owned by two or more banks.⁷⁵ The review and classification of these credits are conducted independently of the regular bank examination by an interagency team of examiners, who review the loans for credit quality. The classification of these credits is then used in the examination of each institution that participated in the loans.

In 1977 the Interagency Supervisory Committee, which included representatives from the five federal banking, thrift, and credit union agencies, was established to coordinate supervisory policies and procedures.⁷⁶ A significant accomplishment of the committee was adoption of the uniform interagency system for rating the condition of banks—the immediate predecessor of the CAMEL rating system. The uniform rating system provided a basis on which the examination findings of all federally insured banks could be compared, so that for the first time meaningful reports on the condition of the nation’s banking system could be given to the public and to Congress.

In 1979, after passage of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRIRCA), the Interagency Supervisory Committee was replaced by the Federal Financial Institutions Examination Council (FFIEC).⁷⁷ The council’s membership consists of the OCC, the Federal Reserve Board, the FDIC, the Office of Thrift Supervision, and the National Credit Union Administration.⁷⁸ The council has established task forces to work on coordination of supervisory activities, uniformity of consumer protection laws and regulations, use of common data-gathering systems, and use of common educational programs. Some of its early accomplishments were standardizing instructions and forms for banks’ quarterly reports of condition and income, bringing uniformity to bank performance reports, instituting interagency examiner training, and preparing a number of uniform supervisory policy statements.

⁷⁴ Ibid. (1981), 183.

⁷⁵ Ibid. (1977), 7–8.

⁷⁶ Ibid. (1978), 9–10.

⁷⁷ Ibid., 9.

⁷⁸ Before passage of FIRREA, the Federal Home Loan Bank Board was represented on the FFIEC.

Box 1***The CAMEL Evaluation Components***

An institution's *Capital Adequacy* is evaluated in relation to the volume of risk assets; the volume of marginal and inferior quality assets; the bank's growth experience, plan and prospects; and the strength of management. Consideration is also given to an institution's capital ratios relative to its peer group, its earnings retention, its dividend policies and its access to capital markets or other appropriate sources of financial assistance. Capital adequacy for the FDIC, the OCC and the Federal Reserve is guided by regulation.

Asset Quality is evaluated by the level, distribution and severity of adversely classified assets; the level and distribution of non-accrual and reduced-rate assets; the adequacy of the allowance for loan losses; and management's demonstrated ability to administer and collect problem credits. In addition, examiners evaluate the volume of concentrations of credit, trends in asset quality, volume of out-of-territory loans, level and severity of other real estate held and the bank's underwriting standards.

Management is evaluated against virtually all factors considered necessary to operate the bank within accepted banking practices and in a safe and sound manner. Thus, management is evaluated in relation to technical competence; leadership and administrative ability; compliance with banking regulations and statutes; adequacy of, and compliance with, internal policies and controls; and whether the board has a plan covering management succession. The assessment of management also takes into account the quality of internal controls, operating procedures and all lending, investment, and other operating policies. Finally, examiners review and assess the composition, experience level, abilities and involvement of the officers, directors and shareholders.

Earnings are evaluated with respect to their ability to cover losses and provide adequate capital protection; trends; peer group comparisons; the quality and composition of net income; and the degree of reliance on interest-sensitive funds. Consideration is also given to the bank's dividend payout ratio, the rate of growth of retained earnings and the adequacy of bank capital. The adequacy of provisions to the allowance for loan losses, and the extent to which extraordinary items, securities transactions and tax effects contribute to net income, are also assessed.

Note: Information in Box 1 and Box 2 is quoted from the FDIC's *DOS Manual of Examination Policies*.

Box 1—continued

Liquidity is evaluated in relation to the volatility of deposits; the frequency and level of borrowings, use of brokered deposits, technical competence relative to the structure of liabilities, availability of assets readily convertible into cash; and access to money markets or other ready sources of funds. The overall effectiveness of asset-liability management is considered, as well as the adequacy of, and compliance with, established liquidity policies. The nature, volume and anticipated use of credit commitments are also factors that are weighed.

Box 2***Definitions of Composite CAMEL Ratings***

Composite “1” — Institutions in this group are basically sound in every respect; any adverse findings or comments are of a minor nature and can be handled in a routine manner. Such institutions are resistant to external economic and financial disturbances and more capable of withstanding the vagaries of business conditions than institutions with lower ratings. As a result, such institutions give no cause for supervisory concern.

Composite “2” — Institutions in this group are fundamentally sound, but may reflect modest weaknesses correctable in the normal course of business. The nature and severity of deficiencies, however, are not considered material and, therefore, such institutions are stable and able to withstand business fluctuations quite well. While areas of weakness could develop into conditions of greater concern, the supervisory response is limited to the extent that minor adjustments are resolved in the normal course of business and operations continue to be satisfactory.

Composite “3” — Institutions in this category exhibit financial, operational or compliance weaknesses ranging from moderately severe to unsatisfactory. When weaknesses relate to financial condition, such institutions may be vulnerable to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Institutions that are in significant non-compliance with laws and regulations may also be accorded this rating. Generally, these institutions give cause for supervisory concern and require more than normal supervision to address deficiencies. Overall strength and financial capacity, however, are still such as to make failure only a remote possibility.

Composite “4” — Institutions in this group have an immoderate volume of serious financial weaknesses or a combination of other conditions that are unsatisfactory. Major and serious problems or unsafe and unsound conditions may exist that are not being satisfactorily addressed or resolved. Unless effective action is taken to correct these conditions, they could reasonably develop into a situation that could impair future viability, constitute a threat to the interest of depositors and/or pose a potential for disbursement of funds by the insuring agency. A higher potential for failure is present, but is not yet imminent or pronounced. Institutions in this category require close supervisory attention and financial surveillance and a definite plan for corrective action.

Composite “5” — This category is reserved for institutions with an extremely high immediate or near term probability of failure. The volume and severity of weak-

Box 2—continued

nesses or unsafe and unsound conditions are so critical as to require urgent aid from stockholders or other public or private sources of financial assistance. In the absence of urgent and decisive corrective measures, these situations will likely result in failure and involve the disbursement of insurance funds to insured depositors, or some form of emergency assistance, merger or acquisition.

Box 3***FDIC Informal and Formal Actions to Correct
Unsafe and Unsound Practices*****Informal Corrective Actions**

Memorandum of Understanding—A memorandum of understanding is the means of seeking informal corrective action from institutions that are considered to be of supervisory concern but have not deteriorated to the point where they warrant formal administrative action. As a general rule this informal action is to be considered for all institutions rated a composite 3. A memorandum of understanding is generally drafted at the regional level and is based on the recommendations of the examiner and the report of examination. This document is signed by the institution's board of directors and a representative of the FDIC, with the state authority invited to join the action. Use of a memorandum of understanding is generally appropriate when the regional office believes that the problems discussed with management and the board of directors of the institution have been adequately detailed and that the institution will move in good faith to eliminate the problems.

Board Resolution—A board resolution is generally used in lieu of, and contains basically the same items as those covered in, a memorandum of understanding. An institution's board of directors, after reviewing and concurring with the problems discussed by the examiner and outlined in the report of examination, adopts a resolution indicating the directors' intent to take corrective action and eliminate the problems. The board resolution is a formal commitment adopted by the bank's board members but is not signed by the FDIC. A board resolution is generally used when the bank is rated a composite 3 and management and the board have demonstrated an ability and willingness to initiate corrective action to eliminate the problems.

Formal Enforcement Actions

Section 8 of the Federal Deposit Insurance Act—Section 8 provides the FDIC's Board of Directors with a broad range of formal administrative enforcement powers. The FDIC Board of Directors has delegated certain Section 8 actions to the various levels within the Division of Supervision and has retained certain authority at the Board level. Banks with composite ratings of 4 or 5 will, by definition, have problems of sufficient severity to warrant formal action. Division of Supervision policy requires the FDIC to take formal action pursuant to Section 8 of the FDI Act against all insured state nonmember banks rated 4 or 5 when evidence of unsafe or unsound practices is

Box 3—continued

present. This enforcement action normally consists of *either* a cease-and-desist order under either Section 8(b) or Section 8(c) *or* initiation of termination of insurance proceedings under Section 8(a). Section 8(e) gives the FDIC the power to order the removal of an institution-affiliated party (director, officer, employee, controlling stockholder, independent contractor, etc.) from office. This section also allows the FDIC to prohibit the party from participating in the conduct of the affairs of any insured depository institution.

Other Actions

Written Agreements/Capital Directives—The use of a written agreement should normally be used for a bank whose problems are limited to a capital deficiency that has not been caused by the unsafe and unsound practices of its management. A written agreement is intended to be used only when a Section 8(a) or Section 8(b) action or a capital directive against a bank is not justified or practical. This document must be between a bank and its primary federal regulator, with the FDIC a party to the agreement. A capital directive is an order to a state nonmember bank that fails to maintain capital at or above its minimum capital requirements, and is to be used solely to correct a capital deficiency.

Prompt Corrective Action—The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires each appropriate federal banking agency to take prompt corrective action to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund. Prompt Corrective Action is a framework of supervisory actions for insured depository institutions that are not adequately capitalized. Other supervisory actions associated with prompt corrective action are discretionary and may be imposed on an institution by the FDIC.

Civil Money Penalties—Although this specific proceeding is not a formal enforcement action, the FDIC and the other federal regulatory agencies have the authority and power to assess civil money penalties in certain situations. The Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRIRCA) gave the FDIC authority to prospectively assess civil money penalties against both banks and individuals. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) significantly increased their applicability and the dollar amount of the penalties that could be assessed. Civil money penalties may be assessed for the violation of any law or regulation, any final order or temporary order issued, any con-

dition imposed in writing by the appropriate federal banking agency in connection with the approval of any application, and any written agreement between a depository institution and federal banking agency. An interagency statement of policy regarding the assessment of civil money penalties was adopted by the FDIC in 1980. This policy statement describes 13 factors an agency should consider in determining whether to pursue civil money penalties.

