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Report to the Chairman, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Committee on Banking, Finance and Urban Affairs, House of Representatives

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BANK SUPERVISION

Prompt and Forceful Regulatory Actions Needed

GAO/GGD-91-69

GAO
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April 15, 1991

The Honorable Frank Annunzio
Chairman, Subcommittee on Financial
Institutions Supervision,
Regulation and Insurance
Committee on Banking,
Finance and Urban Affairs
House of Representatives

Dear Mr. Chairman:

This report was prepared in response to your request that we review the effectiveness of federal bank regulators' enforcement activities to ensure that banks are operating in a safe and sound manner, thereby preserving the health of both the banking industry and the Bank Insurance Fund.

This report, along with our forthcoming report on the causes of bank failures, provides the analytical basis for our recommendations for improving the enforcement process. Those recommendations, contained in a comprehensive set of proposals to strengthen the regulatory environment and the banking industry, are set forth in our recently released report Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

We are sending copies of this report to all members of the Banking Committees as well as to other appropriate congressional committees, federal banking and thrift agencies, and other interested parties. We will also make copies available to others upon request.

This report was prepared under the overall direction of Craig A. Simmons, Director, Financial Institutions and Markets Issues, who can be reached on (202) 275-8678. Other major contributors are listed in appendix VI.

Sincerely yours,

Richard L. Fogel
Assistant Comptroller General

Executive Summary

Purpose

Numerous bank failures and the potential insolvency of the Bank Insurance Fund are serving as catalysts for reform of the deposit insurance system. One cornerstone of a healthy deposit insurance system is the process used by regulators to identify and, to the extent possible, remedy unsafe and unsound banking practices. The Chairman of the Financial Institutions Supervision, Regulation and Insurance Subcommittee of the House Banking, Finance and Urban Affairs Committee requested that GAO review the effectiveness of regulators' enforcement activities to ensure that banks are operating in a safe and sound manner.

GAO studied regulators' actions to enforce safe and sound banking practices by analyzing 72 banks from the universe of banks that as of January 1, 1988, were identified by regulators as having difficulty meeting the minimum capital standards established by regulation. These 72 cases were randomly selected from three locations and were divided equally among the three federal bank regulators—the Office of the Comptroller of the Currency (OCC), the Federal Reserve System (FRS), and the Federal Deposit Insurance Corporation (FDIC). GAO reviewed regulatory examination reports and other pertinent data to (1) identify each bank's specific problems, (2) identify the related regulatory actions taken, and (3) determine whether each bank corrected its capital problems and the underlying causes of these problems.

Background

Regulators monitor the practices and conditions of banks through off-site monitoring and on-site examinations. When examinations identify unsafe or unsound banking practices or conditions, regulators have the authority to use a variety of enforcement actions prescribed by law and banking regulations to get the banks to address the identified problems.

These actions range from informal meetings to formal actions that are enforceable in the courts. For example, regulators may choose to obtain and document bank management agreement to corrections to be made through commitment letters or memorandums of understanding. These actions are considered informal because they are not legally enforceable in court if the agreed-on corrections are not subsequently completed. Stronger, formal actions available include formal written agreements; orders to cease and desist unsafe practices; orders for removal, prohibition, and suspension of individuals from bank operations; and civil money penalties.

Regulators rely on bank capital as a key measure of a bank's health. A bank's capital is generally the same as its net worth—that is, the difference in value between the assets it owns and the liabilities it must pay. Capital provides banks with a cushion to continue operating during periods of losses or negligible earnings. Healthy capital levels enable banks to grow. From a regulatory perspective, minimum capital standards protect the Bank Insurance Fund because capital represents the amount of losses a bank can sustain before it can no longer meet its depositors' claims.

Results in Brief

In about half of GAO's sampled cases, the regulatory process did not result in improved bank capital levels and correction of the underlying causes of bank capital problems. GAO believes the process needs to be improved to achieve better results.

The three federal bank regulators have wide discretion in choosing among enforcement actions of varying severity. Furthermore, they share a common philosophy of trying to work informally with banks to promote cooperation with those having difficulties. This combination of wide discretion and a cooperative philosophy often did not resolve the problems regulators had identified in GAO's sampled cases.

GAO's analysis showed that bank regulators did not always use the most forceful actions available to correct unsafe and unsound banking practices. When they did, the enforcement process produced better results in terms of improving the condition of the bank. In 37 of the 72 cases sampled, the regulators should have been more aggressive in using stronger regulatory measures than they did. These cases involved instances where (1) the underlying causes for problems were known but remained uncorrected and/or (2) the bank had a history of noncompliance with existing enforcement actions or of repeatedly violating banking regulations.

In GAO's sampled cases, bank capital typically was a lagging, rather than a leading, indicator of bank problems. Nevertheless, regulatory enforcement actions tended to focus on capital inadequacy, rather than on the underlying problems, as the key indicator of unsafe and unsound practices.

GAO believes that the regulatory process would benefit from the improved focus and certainty that could be obtained by establishing a system consisting of (1) industrywide measures of unsafe and unsound

practices to complement the capital standards and (2) specific regulatory responses linked to violations of such measures.

GAO's Analysis

Capital Difficulties Flowed From Other Problems

GAO's analysis showed that the capital difficulties of the 72 banks were typically caused by earlier problems involving bank assets, earnings, and/or management. Table 1 provides a breakdown of the 72 banks by those that eventually improved their capital and those that did not. As the table shows, the majority of banks in both groups had both asset an earnings problems that regulators frequently cited as, at least, a reflection of bank management's willingness or ability to handle banking activities effectively.

Table 1: Causes of Capital Problems Among Sampled Banks

Cause of capital problems	Number of banks whose capital condition: Improved (38)	Did not improve (34)	Tota (72
Number of banks with			
Loan losses/ charge-offs	25	34	5
Operating losses	21	31	5
Dividend payments	3	4	
Excessive asset growth	11	8	1
High risk exposure	15	6	2

Table 1 reveals that capital problems were most frequently caused by losses from bad loans or bank operations. However, regulators also citec dividend payments made by banks without sufficient earnings or capita as causing capital erosion. They also attributed bank capital problems tc asset growth that was not accompanied by comparable increases in capital or high exposures to risk created by heavy concentrations in specifi types of assets, industries, or local economies.

The examination reports GAO reviewed showed that regulators had frequently identified asset, earnings, or management problems and had warned bank management that these problems might adversely affect capital. The most frequently cited asset problems involved problem real estate loans, including real estate properties that banks obtained

through foreclosure. The most frequently cited reasons for asset problems involved banks' underwriting practices, such as inadequate lending policies, lax lending practices, or noncompliance with either established bank lending policies or those set by regulation or law.

Clearly, these types of problems relate to the adequacy of basic internal controls, which should be established and adhered to by bank management. GAO's observations from its sample mirror those of a recent OCC study of failed national banks. OCC's study noted that internal management factors, such as inadequate policies and procedures, rather than external economic conditions, have a greater influence on whether a bank will succeed or fail.

Asset problems and the reasons for them cited by regulators often resulted in earnings problems for the banks. Many of the sampled banks could not rely on earnings to augment weak capital positions. Consequently, the losses incurred by these banks had to come from retained earnings or other capital accounts. Fifty-one of GAO's sampled banks experienced serious earnings problems that regulators had been reporting to management for at least a year.

Both earnings and asset problems can often be traced to the quality of management decisions and practices associated with bank activities and investments. Indeed, bank management is one of the key performance dimensions that regulators assess during their on-site exams. Regulators rate bank management on virtually all factors considered necessary to operate the bank. Fifty-nine of the 72 banks sampled were cited by regulators as having management problems, with 34 of them experiencing serious management problems for at least a year.

Management problems regulators cited most frequently for GAO's sampled banks involved a lack of expertise by bank management or a passive board of directors. Other management problems cited are listed in table 2.

Table 2: Management Problems

Type of problem	Number o bank
Management lacked needed expertise	2
Passive board of directors	2
Unwillingness or inability to address prior enforcement actions	2
Inadequate or no system ensuring compliance with laws and regulations	1
Directors lacked needed expertise	1
Key positions inadequately staffed	1
Insider abuse or fraud	1
Dominant bank official	1
Dominant board member(s)	

Note: These types of management problems were cited by regulators in at least 9 of the 72 banks GAO reviewed. More than one problem may have been cited for each bank.

One of the distressing results from GAO's review was the extent to which regulators had identified the types of problems that lead to capital deficiencies at least a year before the point in time that GAO used to draw its sample of banks with capital problems. For example, in examination reports dated prior to January 1, 1988, regulators had identified serious problems with assets in 61 percent of GAO's sampled banks, earnings problems in 71 percent of the banks, and management problems in 47 percent of the banks.

Capital difficulties typically followed problems in other aspects of the banks' operations. For example, management weaknesses resulted in poor lending policies. These policies, in turn, eventually resulted in a high level of bad loans. As these bad loans defaulted, the banks' earnings suffered. After a period of poor earnings, bank capital was depleted.

Clear-cut regulatory measures of unsafe and unsound practices exist for capital but not for other aspects of bank operations such as asset or earnings quality. This lack places the focus for enforcement on a valid, but lagging, indicator of the safety and soundness of a bank's operations rather than on factors leading to capital depletion. Regulators had internal measures to help them assess a bank's asset and earnings performance, but these internal measures had not been defined in regulations as minimum conditions of safe and sound banking.

Better Results From Forceful Actions

GAO's analysis showed that the regulatory process had better outcomes when regulators took the most forceful action available to them, given the circumstances in individual cases.

Of GAO's 72 sampled cases, 22 banks improved both their capital levels and addressed the underlying cause of their capital problems. In 15 of these "best-outcome" cases, regulators had taken the strongest actions available to them given the circumstances in those cases. Conversely, 20 banks neither improved their capital nor addressed the underlying causes of their capital difficulties. In 14 of these "worst-outcome" cases, regulators had chosen not to use the strongest formal enforcement actions that were available to them.

GAO's analysis of the 72 cases showed that there was a statistically significant relationship between the outcome and the enforcement actions taken. That is, better outcomes were associated with the most forceful actions taken, and worse outcomes were associated with not taking the most forceful actions available.

Why did the regulators not take stronger action when they could have? One reason was that they focused primarily on correcting capital problems rather than on underlying causes of capital depletion. Additionally, all three regulators favor working with cooperative bank managers to get them to address identified problems. OCC officials advised GAO that OCC consciously decided in the mid-1980s to change its philosophical approach by trying to work more cooperatively with bank managers so as to encourage them to make necessary improvements rather than by imposing formal enforcement actions to compel managers to act. While FDIC and FRS officials did not cite a similar change in philosophy, they too expressed a preference for working with cooperative bank management rather than imposing formal enforcement actions.

GAO does not object to regulators working cooperatively with bankers as long as the latter are responsive in addressing the safety and soundness problems identified. However, GAO is concerned that if the cooperative approach is carried too far without obtaining positive results, it can prove damaging over the longer term because underlying problems can become intractable. There is a point in the regulatory process where more forceful actions need to be brought into play. GAO believes the present regulatory practice may extend that point too far.

For example, GAO identified 37 cases in its sample where regulators decided not to use available enforcement actions. The reasons cited for

not taking more forceful actions in these cases were consistent with the regulators' reliance on capital as a measure of a bank's financial health and viability. Regulators clearly did not want to take an enforcement action that they believed would potentially damage the bank's ability to attract capital through injections, stock offerings, mergers, or acquirers; nor did they want to take action until capital levels fell below minimum standards.

In 26 cases, the unsafe and unsound practices that caused the capital depletion remained uncorrected. In 35 cases, management had not fully complied with the existing enforcement actions, regulators had identified repeated violations of banking laws and regulations, and/or regulators had questioned involvement of the bankers in insider activity violations.

More Certainty Could Improve Regulatory Process

GAO believes that better focus and greater certainty would improve the outcomes of the bank regulatory process. In particular, GAO believes the process would benefit by establishing (1) industrywide measures of safety and soundness for asset, management, and earnings conditions to complement the capital standards; and (2) a prescribed set of increasingly strong enforcement actions to be taken when a bank does not satisfy these measures.

Such measures established in regulation would provide benchmarks for all parties involved—bank managers as well as regulators. GAO believes such a "tripwire" system would help both regulators and bank management focus on problems that, if not corrected, will likely lead to capital deficiencies.

The tripwire approach would categorize the regulator's response into phases of intervention that become increasingly more severe as a bank's condition deteriorates. Such phases might include (1) problems involving internal or management controls over banking operations that have not yet resulted in high levels of nonperforming assets or operating losses; (2) problems in assets, earnings, management, or liquidity that have not yet affected bank capital; (3) problems in bank operations that have affected capital and deterioration have caused the bank to fall below minimum capital standards; and (4) problems that have depleted bank capital.

GAO further believes that such a system would eliminate some of the discretion presently available to both bank managers and regulators

that appears to be leading to ineffective results. However, GAO also believes that regulators should continue to have discretion to waive specific enforcement actions so long as the reasons for such deviations have been justified, documented, and approved.

Recommendations

Meaningful reform of the deposit insurance system will not succeed without an enforcement process that is more predictable, more credible, and less discretionary than the approach now used. For this reason, it is essential that Congress require bank regulators to implement a tripwire approach to bank regulation that obligates them to take early and forceful regulatory action tied to specific unsafe banking practices.

The specifics of GAO's tripwire proposal for increasing the predictability and effectiveness of the current enforcement process are contained in GAO's recently issued report, Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

Agency Comments

GAO sought comments on a draft of this report from FDIC, FRS, and OCC. All three federal bank regulatory agencies agreed that the regulatory focus must extend beyond capital to other factors that cause capital depletion and jeopardize the bank's financial health and viability. They also agreed that prompt and forceful enforcement actions are warranted to address unsafe and unsound practices or conditions that regulators identify in bank operations.

Nevertheless, they generally did not want to be constrained in their decisionmaking by a "tripwire" type approach for all components of bank operations. The regulators raised concerns about the feasibility of establishing quantifiable measures for all components of bank operations that are examined—particularly for bank management—and about the discretion that regulators need to consider the specific facts and circumstances of each bank examined in determining the most appropriate enforcement action to take.

GAO is also sensitive to the need for regulatory discretion and believes the tripwire approach would reduce—not eliminate—discretion for all parties affected by bank regulation, including regulators, bankers, and others. GAO believes quantifiable measures for all bank components, including management, can be established and is willing to work with Congress and the federal bank regulators as they develop a framework for the tripwire approach. Regulators would be able to waive specific

enforcement actions, but deviations would have to be justified and documented. (See pp. 42-45.)

Agency comments and GAO's responses are summarized in chapter 3 and in appendixes I through III.

Contents

Tables

Abbreviations

BIF	Bank Insurance Fund
CAMEL	capital adequacy, asset quality, management performance, earnings, and liquidity
C&D	cease and desist order
CMP	civil money penalty
FDIC	Federal Deposit Insurance Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
FRS	Federal Reserve System
MOU	memorandum of understanding
OCC	Office of the Comptroller of the Currency

Introduction

Concerns about the condition of the banking industry have been widely reported. These concerns have been fostered by, among other things, over 200 bank failures in each of the last 3 years and consecutive losses to the Bank Insurance Fund (BIF) in 1988 and 1989, totalling about $4 billion. According to the Federal Deposit Insurance Corporation (FDIC), at the present pace, the number of bank failures for 1990 will be below 200 for the first time since 1986. However, the FDIC Chairman has estimated that the 1990 failures will result in a $4 billion loss to the insurance fund and thereby seriously deplete the fund balance. In fact, in congressional testimony in January 1991, the Chairman predicted that BIF will not be able to cover bank losses without additional funding if the current recession lasts longer than 6 months.

GAO is among those who have raised concerns about the weakening condition of the banking industry and whether BIF has sufficient funds to deal with continued high numbers of bank failures—particularly in a recession.[1] The risk of losses facing the banking industry is reflected by an industry loan portfolio with large exposures in real estate, commercial loans, and loans to less developed countries. Real estate concentrations, in particular, have contributed to banks' recent financial problems. These loans constitute over 30 percent of banks' portfolios. Moreover, almost $90 billion of the $800 billion in real estate loans are either noncurrent or foreclosed. Given the potential for further weakening in real estate markets, banks are increasingly exposed to further loan losses.

Background

Federal bank regulators rely on two primary safeguards to ensure a safe and sound banking system as well as to protect BIF. One safeguard is the promulgation of policies and regulations that generally prescribe safe and sound banking activities. Among the most important of these are regulations dealing with minimum capital standards that provide benchmarks against which regulators can assess the safety and soundness of a bank's operations as well as its financial condition. Bank supervision is the other primary safeguard, accomplished through off-site monitoring systems and on-site bank examinations. Such supervision may result in regulators taking enforcement actions against banks found to be engaging in unsafe and unsound practices or violations of law or other regulatory guidelines.

[1] Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, Sept. 11, 1990).

Until December 31, 1990, banks were required to maintain total capital equal to 6 percent of their total assets, and 5.5 percent of total assets had to consist of primary capital. Primary capital generally included common stockholders' equity, all forms of perpetual preferred stock, the entire allowance for loan and lease losses, and certain amounts of mandatory convertible debt. Total capital included primary capital plus limited life preferred stock, subordinated notes and debentures, and a portion of mandatory convertible debt.

These required capital standards are only minimum levels for fundamentally sound, well-managed banks with no material weaknesses. Regulators have the authority to require higher capital levels for banks operating in an unsafe and unsound condition, such as those with large loss exposures arising from high levels of potentially bad loans.

Capital provides banks with a cushion to enable continued operation during periods of losses or negligible earnings. It also supports banks' ability to grow. Minimum capital standards serve as a constraint against imprudent growth since a proportional increase in capital must accompany any increases in assets. Furthermore, minimum capital standards protect the BIF because capital represents the amount of loss that can be sustained before a bank is unable to meet depositors' claims.

The importance of bank capital is recognized internationally. In fact, all U.S. commercial banks are subject to new international risk-based capital standards that will be fully implemented by December 1992. Banks have been converting to this new risk-based capital standard, which will require banks to maintain total capital of 8 percent of that portion of their assets subject to credit risk. In addition, federal bank regulatory agencies have established Tier I (core) capital requirements of at least 3 percent of total assets. Risk-based capital requirements are based on the types of assets—rather than on the total assets—that banks have in their portfolios. For example, more capital would be required for commercial or real estate loans than for investments in government securities. In addition, various proposals for expanding bank powers into activities such as insurance and securities and for reforming the current deposit insurance system are based on banks being adequately capitalized and having a strong regulatory process to ensure capital standards are met.

Supervision of Federally Insured Commercial Banks

Responsibility for ensuring that the approximately 13,000 federally insured commercial banks meet minimum capital standards—as well as adhere to other regulations—is shared among three federal banking agencies. The Federal Reserve System (FRS) has principal supervisory responsibility for the approximately 1,000 state-chartered banks that are members of the Federal Reserve System and for all bank holding companies. FDIC is the primary regulator for the almost 8,000 state-chartered banks that are not members (referred to as nonmember banks) of FRS. The Office of the Comptroller of the Currency (OCC) supervises about 4,000 nationally chartered banks. State banking authorities also have supervisory responsibility for state-chartered banks.

The three federal banking agencies monitor banks' financial condition and performance through off-site monitoring systems using reports that banks file with their primary regulator. Regulators also conduct on-site examinations to ensure that bank operations are consistent with sound banking practices and banking laws and regulations. Normally, after completing an on-site examination, bank regulators assign a numeric rating to reflect their assessment of the bank's financial condition, compliance with laws and regulations, and overall operating soundness. Commonly referred to as the CAMEL rating, regulators rate each of the following bank performance dimensions or components: capital adequacy, asset quality, management performance, earnings, and liquidity. Although no arithmetic average of the CAMEL components is calculated, an overall composite rating is assigned that takes into account these and other subjective factors regarding the bank's overall financial condition, along with the safety and soundness of its operations.

CAMEL component and composite ratings range from 1 to 5. A 1 rating is the best rating and represents the lowest level of supervisory concern; a 5 rating is the worst, representing the most critically deficient level of performance and thus the highest degree of supervisory concern. A 3 rating, which signals moderately severe to unsatisfactory conditions in bank operations, reflects the need for more than normal supervisory attention.

When regulators identify unsafe practices and/or violations, they may use various enforcement actions to get banks to address and correct identified weaknesses and violations. In some instances, such as the assessment of civil money penalties (CMP), enforcement actions serve as a punitive measure for operating in an unsafe manner or violating regulations and laws.

Enforcement Actions Available to Bank Regulators

The enforcement process for all three regulators begins when they notify bank management and directors of financial weaknesses, operational problems, or violations of banking laws or regulations identified during an examination. Regulatory concerns are to be brought to a bank's attention through meetings with bank management. After completing the examination, a report of examination findings is to be provided to the bank's board of directors, management, or principal ownership interests. Meetings and examination reports enable regulators to convey their supervisory concerns, as well as to impress upon bank management the need to address those areas that adversely affect the bank's continued viability. Regulators may initiate informal or formal enforcement actions to get bank management to take corrective action to address the problems identified.

According to agency guidelines, regulators are to use informal actions for banks in which—despite identified problems and weaknesses—the overall strength and financial condition reduce failure to a remote possibility, and bank management has demonstrated a willingness to address supervisory concerns. Informal actions are to be used to advise banks of noted weaknesses, supervisory concerns, and the need for corrective action. This may include persuading bank management to take actions like strengthening its loan policies or increasing its reserves for future loan losses. Informal actions include

- meeting with bank officers or boards of directors to obtain agreement on improvements needed in the safety and soundness of the bank's activities,
- having banks issue commitment letters to the regulators specifying corrective actions that will be taken,
- having bank boards issue resolutions specifying corrective actions that need to be taken, and
- initiating a memorandum of understanding (MOU) between regulators and bank officers on actions that will be taken.

While informal actions communicate supervisory concerns and actions needed to address those concerns, they are not administratively or judicially enforceable in the event that agreed upon corrective actions are not taken by bank management.

Regulators are to use formal enforcement actions if (1) informal actions have not been successful in getting bank management to address supervisory concerns, (2) bank management is uncooperative, or (3) the bank's financial and operating weaknesses are serious and failure is

more than a remote possibility. Formal actions are legally enforceable tools that regulators can use to compel banks to take corrective actions to address such supervisory concerns as discontinuing abusive lending practices or strengthening underwriting policies. These actions include

- formal written agreements between regulators and bankers;
- orders to cease and desist unsafe practices and/or violations;
- assessments of CMPs; and
- orders for removal, prohibition, or suspension of individuals from bank operations.

Formal actions are authorized by statute and may be taken by all three regulators against the banks they supervise. FDIC has the sole legal authority to terminate deposit insurance. If banks do not consent to a formal action or fail to comply with its provisions once agreed upon, regulators may enforce the action through administrative proceedings or in the courts.

Regulators' Use of Available Enforcement Actions

Banking laws, regulations, and agency guidelines generally delineate the conditions that must be present for regulators to use available enforcement actions. However, beyond the minimum capital standards, the delineation does not include specific measures or standards of what would constitute a threshold unsafe practice or condition. Because of this lack of specificity, regulators have considerable discretion in deciding how serious a problem is, whether to use formal enforcement actions, and which among those actions to use.

Each banking agency has delegated, to varying degrees, enforcement authority to their field offices. In general, these offices may take informal actions and some of the less contentious formal actions such as written agreements—which, while formal, were not made public like cease and desist orders (C&D) until the passage of the Crime Control Act, which was enacted on November 20, 1990. The enforcement actions that require headquarters involvement and/or authority primarily consist of those actions likely to be contested by bankers. These actions are generally not delegated to field offices. The regulatory agency wants to ensure that it has sufficiently considered all the legal and policy implications of the proposed action along with the likelihood the agency can sustain its position through administrative or judicial proceedings.

Regulators' authorities regarding enforcement actions were expanded and enhanced by the Financial Institutions Reform, Recovery, and

Enforcement Act (FIRREA) of 1989. While these enhancements did not include more precise delineations of what constitutes unsafe or unsound banking practices, they did—among other things—enable federal banking agencies to halt such practices more expeditiously and forcefully. For example, regulators may now issue removal orders for any bank official found to be engaging in unsafe and unsound practices that could be expected to result in loss to the bank; regulators also can now assess CMPs up to $1 million a day.

Objectives, Scope, and Methodology

In light of the problems facing the banking industry, the Chairman of the House Subcommittee on Financial Institutions, Supervision, Regulation, and Insurance of the Committee on Banking, Finance and Urban Affairs asked us to review the effectiveness of regulators' enforcement activities to ensure that banks are operating in a safe and sound manner, thereby preserving the health of both the banking industry and BIF. Since banks' ability to meet minimum capital standards is critical among safety and soundness measures used by regulators, we focused our review on the actions taken by regulators to deal with banks identified as having difficulties meeting capital standards. This report discusses how federal bank regulators used the enforcement tools available to them to deal with banks they had (1) identified as having capital problems and (2) found to be engaging in unsafe and unsound banking practices that could lead to capital depletion.

We reviewed the examination reports and related materials of a sampling of banks with known capital problems. We identified and reviewed the informal and formal enforcement actions that regulators used to get the sampled banks to address their capital deficiencies and unsafe and unsound banking practices, including violations of banking laws and regulations. To identify the regulatory practices used, we primarily relied on regulators' enforcement files and the examination reports that were sent to the sampled banks after an examination. We then assessed regulators' supervisory actions against each agency's internal policies and guidelines, and, if applicable, the statutory authority for the use of formal enforcement actions.[2]

Specifically, from bank examination records of each of the three federal regulators, we identified 2,720 banks with a CAMEL rating of 3, 4, or 5 as

[2]We did not assess regulators' off-site monitoring systems or the adequacy of the on-site examinations that formed the basis for regulatory concerns that were reflected in the examination reports.

of January 1988. The banks that were examined in either the San Francisco, Chicago, or Dallas bank regulatory offices represented 1,494, or 55 percent, of these 2,720 banks. We randomly selected 72 of these 1,494 banks, evenly divided for each of the regulatory agencies and each of the locations.

Even though our sampled banks were randomly selected, we did not believe our review of 72 cases would be a sufficient number to allow us to generalize our observations across either the nation, each location, or each agency. The time and resources necessary to review a larger number of banks were prohibitive. We did discuss our sampling approach with supervisory officials at both the headquarters and field offices of each agency. They agreed that our approach was reasonable and that our results should be indicative of how field offices were using available enforcement tools to get banks to address supervisory concerns on banks with identified capital problems.

However, in analyzing the results of our 72 sampled cases, we were struck by the dramatic differences in the outcomes—improved capital and corrected underlying causes—of cases in which regulators took the most forceful available action as opposed to those in which the available actions were not taken. We ran statistical tests of our results to determine whether there was a statistically significant association between the outcomes and the actions taken. A statistically significant association gives us confidence that our results were not just random occurrences. Such an association, therefore, would allow us to generalize our results over the universe of capital-deficient banks in the three geographic locations from which we sampled.

For each of the sampled banks, we analyzed key documents such as examination reports, enforcement related memoranda, internal and external correspondence, and supervisory enforcement files. We supplemented our document and file reviews with extensive interviews of agency officials who were responsible for supervising the sampled banks. If records or local officials indicated headquarters involvement, we also interviewed headquarters officials and reviewed their related files. Although our analysis covers banks that regulators identified as having capital problems as of January 1988, we reviewed records covering earlier periods if there were indications that problems and weaknesses had been identified before January 1988. We also reviewed all records up to the time we completed our field work—September 1990—to identify all regulatory actions taken and changes in the banks' conditions.

Our fieldwork was done in the three federal bank regulators' offices in San Francisco, Chicago, and Dallas, as well as their Washington, D.C., headquarters offices, from February through September 1990 in accordance with generally accepted government auditing standards.

Capital Depletion Caused by Problems in Assets, Earnings, and/or Management

From our review of banks with capital problems, we found that regulators had previously identified problems related to assets, earnings, and/or management and had already brought those problems—along with concerns about their potential adverse impact on bank capital—to the attention of bank managers and directors. These problems had invariably been brought to the banks' attention before the problems cited actually caused capital depletion. The problems regulators identified typically reflected weaknesses in banks' internal control systems, such as inadequate loan policies or lax lending practices.

In 69 of our 72 sampled banks, regulators attributed the bank's capital problems in January 1988 to asset problems, with 44 of them having experienced serious asset problems that regulators had been reporting to management for at least a year—as reflected by asset component ratings of 4 or 5 and accompanying narrative explanations in earlier examination reports. For the most part, asset problems led to earnings problems, which ultimately depleted bank capital. While asset problems were primarily related to real estate loans, regulators attributed most of the problems, regardless of the loan type, to poor lending practices such as underwriting loans without established lending policies and procedures. Losses from nonpayment or foreclosure of these loans typically affected bank earnings adversely. Asset and earnings problems and their ultimate impact on capital were frequently cited by regulators as, at least, a reflection of bank management's involvement in or competence to handle banking activities effectively. Liquidity was rarely cited as a factor contributing to banks' capital depletion.

Asset Problems Most Frequently Cited as Causing Capital Depletion

The most frequently cited asset problems involved problem real estate loans, including real estate properties that banks obtained through foreclosure. Regulators also identified other broad categories of problem assets such as agricultural, commercial and industrial loans as, at least, having a potentially adverse effect on capital. The type of loan was of particular concern to regulators when they saw considerable concentrations or growth—e.g., large proportions of the loan portfolio concentrated in commercial real estate loans. However, their concerns about the quality of the assets were largely attributed to either the adequacy of the banks' loan policies or adherence to those policies.

Table 2.1 shows the major types of problem assets that regulators cited in examination reports for the 72 sampled banks. There were no significant differences in the types of problem assets cited by regulator; differences by geographic location are detailed in table II.1.

Table 2.1: Problem Assets

Type of problem asset	Number of banks
Real-estate-related loans	33
Other real estate owned[a]	26
Agricultural loans	23
Commercial and industrial loans	22
Participation loans[b]	7

Note: These problem assets were cited by regulators in at least 7 of the 72 banks we reviewed; more than one type of asset problem may have been cited for each bank.

[a]Other real estate owned is, for the most part, property the bank repossessed as a result of a loan foreclosure.

[b]Loan participations consist of loans shared among two or more banks. Loan participations provide banks with a means of diversifying their portfolios and reducing the amount of potential losses due to default by any one borrower.

Other types of problem assets such as highly leveraged transactions, investment securities, and affiliate transactions were also cited by regulators but affected fewer than seven of the sampled banks.

During on-site examinations, regulators routinely review loan portfolios to ensure that banks have sufficiently identified loans exhibiting higher than normal risk of default. Banks are supposed to manage their loan portfolios to identify problem loans including those that are nonperforming, i.e., those where payments are not current. They are also supposed to establish reserve accounts to effectively set funds aside in the event the loans later prove to be uncollectible. If the bank's loan portfolio does not accurately reflect the value of its loans or existing reserves for future losses are insufficient, regulators may require banks to set aside additional funds for future loan losses. The additional loan loss reserves, in effect, reduce current earnings, and, if there are no earnings or insufficient earnings, the reserves reduce retained earnings or other capital accounts.

Table 2.2 shows the major reasons cited by regulators for asset problems in our 72 sampled cases. There were no significant differences among the asset problems cited by regulators; differences by geographic location are detailed in table II.2.

Table 2.2: Major Reasons for Asset Problems

Reasons	Number of banks
Inadequate bank underwriting policies and procedures	57
Liberal/lax lending practices	43
Depressed local economy	40
Nonadherence to established bank policies and procedures	21
Violations of lending laws/regulations	20
Lack of diversification	13
Insider abuse or fraud	8
Overreliance on out-of-territory lending	6

Note: These reasons were cited by regulators in at least six of our sampled banks; more than one reason may have been cited for each bank.

The most frequently cited reasons for asset problems involved banks' underwriting practices such as the inadequacy of their lending policies, the laxness of their actual lending practices, or noncompliance with either established bank lending policies or those set by regulation or law.

Although a depressed local economy affected over half of the sampled banks, we found that regulators seldom cited this reason alone. A depressed economy was invariably coupled with unsafe lending practices, such as having inadequate underwriting policies and procedures or having liberal lending practices. Only in one case did examiners cite a depressed economy as the only contributing reason for the bank's asset problems.

Concentrations or the lack of diversification in the bank's loan portfolio was cited for 13 of our sampled banks. Other issues cited included insider abuse or fraud and an overreliance on out-of-territory lending. Insider abuse and fraud consisted primarily of insider lending abuses involving bank management and directors and the misapplication of bank funds. In addition to citing these abuses as asset quality problems, regulators had also made criminal referrals to the Justice Department in some of these sampled cases.

In our sampled cases, most of the reasons cited by regulators for asset problems clearly related to the adequacy of basic controls (e.g., lending policies and procedures) that are to be established and adhered to by bank management. Even instances of material insider abuse or fraud can generally be minimized by diligent bank management and control systems.

Our observations mirror a recent OCC study of failed national banks. The OCC study noted that internal management factors, such as inadequate policies and procedures, rather than external economic conditions have a greater influence on whether a bank will succeed or fail.[1] Furthermore, the study reports that unsafe lending practices exacerbate problems arising from external economic factors, thus increasing the likelihood of a bank failing.

These observations are also consistent with the major reasons we reported for losses to BIF—i.e., inadequate internal and management controls in banks that either failed or required assistance.[2]

Senior regulatory officials advised us that, from their experience, heavy concentrations and excessive growth are among the most common reasons for problem assets having an adverse effect on bank earnings and capital. They believe these reasons, combined with poor lending practices or controls, pose serious risks to banks' viability. Concentrations may be by industry, geographic area, or type of loan; all of these result in insufficient portfolio diversification. Excessive growth involves bank investments in assets that are not accompanied by at least proportional growth in bank capital. According to these regulatory officials, concentrations and growth expose banks to greater risk of loss due to downturns in related sectors of the economy.

Loan Losses Adversely Affect Bank Earnings and Capital

Asset problems and the reasons cited by regulators for them often resulted in earnings problems. Many of the sampled banks could not rely on earnings to augment weak capital positions. Consequently, the losses incurred by these banks had to come from retained earnings or other capital accounts. Fifty-one of our sampled banks experienced serious earnings problems that regulators had been reporting to management for at least a year—as reflected by earnings component ratings of 4 or 5 and accompanying narrative explanations in earlier examination reports.

Regulators primarily attributed earnings problems to heavy loan losses. Loan losses and other nonperforming assets necessitated large loan loss provisions that, in effect, reduced current earnings. Another aspect of

[1]Bank Failure, An Evaluation of the Factors Contributing to the Failure of National Banks, Office of the Comptroller of the Currency, June 1988.

[2]Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Bank Insurance Fund (GAO/AFMD-90-100, Sept. 11, 1990).

earnings problems cited by regulators involved weak interest margins created when, for example, banks have a large level of assets that are not producing earnings coupled with the high interest rates they have to pay to attract depositors.

Finally, some of the banks were plagued with high overhead expenses, including personnel costs, legal fees incurred to work out problem loans, and other expenses related to bank operations. Collectively, these factors adversely affected earnings and caused capital depletion for many of our sampled banks.

Management Involvement and Capabilities Cited as Problems Contributing to Capital Depletion

As noted above, both earnings and asset problems can often be traced to the quality of management decisions and practices associated with bank activities and investments. Indeed, bank management is one of the key performance dimensions that regulators assess during on-site examinations. Regulators rate bank management on virtually all factors considered necessary to operate the bank. In 59 of our sampled banks, regulators had attributed the bank's capital problems in January 1988 to management problems, with serious management problems that regulators had been reporting to management for at least a year—as reflected by management component ratings of 4 or 5 and accompanying narrative explanations in earlier examination reports. These low ratings are assigned by regulators when management performance was viewed as threatening the viability of the bank unless corrected or the quality of management could adversely affect bank capital.

Table 2.3 shows the reasons most frequently cited by regulators for banks' management problems in our 72 sampled banks. There were no significant differences by either the regulators or geographic locations in the management problems cited.

Table 2.3: Management Problems

Type of problems	Number of banks
Management lacked needed expertise	27
Passive board of directors	25
Unwillingness or inability to address prior enforcement actions	21
Inadequate or no system ensuring compliance with laws and regulations	15
Directors lacked needed expertise	13
Key positions inadequately staffed	13
Insider abuse or fraud	13
Dominant bank official	10
Dominant board members	9

Note: These reasons were cited by regulators in at least nine of the banks we reviewed, and more than one reason may have been cited for each bank.

The overriding management problems cited by regulators involved bank management's capabilities, involvement, and interest in dealing effectively with bank operations. These problems, along with inadequate management control systems, inadequate staffing of key positions (e.g., loan officers) and insider abuse and dominant bank officials were among the most frequently cited reasons for management problems.

These results are somewhat alarming considering most involved either bank managers' or directors' unwillingness or inability to deal with bank problems that were within their control.

Liquidity Not Often Cited as Reason for Capital Problems

Bank liquidity was not often cited by regulators as a major problem straining bank capital. In only 9 of our 72 sampled banks had regulators attributed the capital problems in January 1988 to serious liquidity problems that they had reported to management for at least a year—as reflected in a 4 or 5 liquidity component rating and accompanying narrative explanation in prior examination reports. Liquidity would not normally be expected to affect capital. Instead, it represents a bank's ability to accommodate decreases in deposits and other liabilities due to unexpected balance sheet fluctuations. In other words, liquidity serves to protect a bank against a "run" by its depositors.

Capital Is a Valid But Lagging Indicator of a Bank's Financial Health and Viability

The results of our review of the 72 banks confirmed the importance of capital as a regulatory safeguard and a measure of a bank's financial health and viability. It is the only measure of a bank's operations that regulators assess that has an established industrywide standard that is quantifiably measured. Although the capital standards provide quantifiable measures for assessing a bank's financial condition, similar industrywide measures are not available in banking laws or regulations to assess the quality of a bank's assets, earnings, or management. Regulators do use various measures (e.g., the ratio of asset concentrations to capital in various types of loans) to assess other components (e.g., assets). However, these measures are not accepted industrywide, nor are they provided for in banking regulations. Therefore, regulators can only use those measures internally as indicators of problems without being able to cite them as violations that, by definition, constitute unsafe and unsound banking practices or conditions.

While we found that capital was a valid measure of a bank's financial health, we also found that it was a lagging indicator of the safety and soundness of a bank's operations: waiting until the capital standards have been violated may be too late for a bank to be able to address its problems regardless of the action taken by the regulator at that time. The reason we believe, and regulators agree, that capital is a valid but lagging measure is that regulators had invariably identified problems in the bank's asset, earnings, and/or management components before those problems actually affected bank capital.

Conclusions

The causes of weakened capital condition in the 72 banks we sampled indicate that other symptoms of weakness, such as asset and earnings problems resulting from significant management problems, contributed to capital deficiencies. Serious problems in assets, earnings, and/or management had been identified and reported to bank management by at least January 1987 along with the regulators' concerns about their adverse impact on capital. These problems, if left uncorrected, invariably led to an erosion of capital. In the next chapter, we analyze why these problems went uncorrected when the supervisory process had identified them and brought them to management's attention. We also discuss ways to remedy this situation.

The Most Forceful Enforcement Actions Gave Better Results

About half of our sampled banks were successful in restoring their capital, but fewer were successful in correcting the underlying asset, earnings, or management problems that caused the capital depletion. When these underlying causes were not addressed, banks continued to be exposed to further losses and capital depletion.

Regulators have considerable discretion in choosing which, if any, enforcement action to take for identified unsafe and unsound practices. In addition, for a number of years, they have operated under a philosophy of working with cooperative bank management. We believe the combination of this discretion and philosophy has resulted in an increasing regulatory reliance on less forceful enforcement actions. This reliance, in many instances, was ineffective in resolving supervisory concerns and, in some cases, appeared to be an inappropriate response to safety and soundness concerns.

Opportunities exist to improve the effectiveness of the regulatory process by providing better focus through industrywide measures and greater certainty regarding regulatory responses to violations of those measures.

Supervisory Process Had Better Results When Forceful Action Was Taken

In reviewing the enforcement histories of the 72 sampled banks, we analyzed a variety of attributes. In particular, we collected data on

- the cause of supervisory concerns;
- the type and severity of enforcement actions taken;
- the instances of noncompliance with banking laws, regulations, or prior enforcement actions; and
- outcome measures such as whether the bank improved its capital condition and corrected the underlying causes of its problems.

Appendix III gives the case-by-case results for each of these attributes.

Our case analysis showed that regulators did not always use the most forceful actions available to correct unsafe and unsound banking practices. But when they did, the enforcement process produced better results. This factor was the single case attribute that was associated with positive outcomes from the supervisory process. Other case attributes did not show a statistically meaningful relationship between enforcement actions taken and the positive outcomes for these capital-deficient banks.

Factors Leading to Supervisory Concerns

As we reported in chapter 2, the underlying problems that caused capital depletion had been identified at least by January 1987. We categorized the banks according to whether their capital condition improved or not during the period from January 1988 through September 1990 and compared the causes that had led to the capital problems for each category.

Table 3.1 shows factors that reflect asset and earnings problems were prevalent both in banks that did and those that did not improve their capital position during the period from January 1988 through September 1990. These assets and earnings problems were frequently cited by regulators as, at least, a reflection of management's willingness or ability to handle banking activities effectively. Such factors were slightly more prevalent for most banks that did not improve capital.

Table 3.1: Causes of Capital Problems Among Sampled Banks

	Number of banks whose capital condition		
Causes of capital problems	**Improved (38)**	**Did not improve (34)**	**Total (72)**
Number of banks with			
Loan losses/charge-offs	25	34	**59**
Operating losses	21	31	**52**
Dividend payments	3	4	**7**
Excessive asset growth	11	8	**19**
High risk exposure	15	6	**21**

As the table shows, capital problems were most frequently caused by losses from bad loans or bank operations. However, regulators also cited dividend payments made by banks without sufficient earnings or capital as causing capital erosion. They also attributed bank capital problems to asset growth that was not accompanied by comparable increases in capital or high exposures to risk created by heavy concentrations in specific types of assets, industries, or local economies.

Enforcement History

While there were no compelling differences in the factors cited as supervisory concerns, we noted that banks that improved capital and those that did not appeared to have been treated differently by regulators. Table 3.2 gives the enforcement summary for the 72 cases.

Table 3.2: Enforcement History for Sampled Banks

Enforcement history	Number of banks whose condition: Improved (38)	Did not improve (34)	Total (72)
Total banks with			
No actions taken	11	2	**13**
Informal action only	5	7	**12**
Some formal action	22	25	**47**
More forceful actions available but not taken	14	24	**38**

The table shows that regulators chose to use a less forceful enforcement action than was available to them given the circumstances in 38 of our 72 sampled banks. In these cases, regulators' description of bank problems, as reflected in examination reports, clearly established an appropriate basis for taking more forceful enforcement actions. In fact, in some cases, the examination reports or related files cited the regulator's authority for particular actions that had been considered even though they were not actually taken.

Regulators chose to use less forceful actions both in cases that improved and those that did not. But fewer actions were foregone in 14, or 37 percent, of the banks that improved their capital conditions than in the 24, or 71 percent, of those that did not improve their capital conditions.

Underlying Causes of Capital Problems Not Always Corrected

We also examined whether the underlying problems that caused capital depletion were corrected after the regulator identified them. If the problem was corrected, we evaluated whether the regulatory action could reasonably be assumed to have contributed to the correction of the underlying problem. Table 3.3 shows the numbers of cases in which the underlying cause of capital depletion was corrected, partially corrected, or not corrected.

Table 3.3: Results of Enforcement Actions

Enforcement results	Number of banks whose capital Improved (38)	Did not improve (34)	Total (72)
Underlying causes of capital problems addressed			
Yes	22	8	**30**
Partially	10	6	**16**
No	6	20	**26**

Causes Corrected, Capital Improved

As table 3.3 indicates, in 22 of 72 cases both the underlying causes of capital depletion were corrected and the capital level improved. In eight other cases, the underlying cause of capital problems had been corrected but capital levels remained low. This result is consistent with the observations from chapter 2 that capital is a lagging indicator. While the underlying problem may have been remedied, a period of positive earnings was needed to restore capital to healthy levels.

Cause Fully/Partially Corrected, Capital Improved

Table 3.3 also shows that there were 32 cases in which banks (1) improved their capital and (2) fully or partially corrected the underlying cause of capital problems. By comparing the provisions of the enforcement actions with the steps taken by bank management to address the problems identified, we determined that in 22 of the 32 cases the regulatory actions were at least partly responsible for these improvements. In the other 10 cases, the improvements resulted from external factors, such as an improved local economy or a legal settlement that boosted the banks' capital. Regulators believed that in at least 5 of these cases, improvement would only be temporary because the underlying problems continued to jeopardize the viability of the banks.

Cause Partially or Not Corrected, Capital Improved

Of the 16 cases that improved capital but did not fully correct the underlying problems, there were 5 whose capital improvements resulted from external factors. Regulators believed that in at least one of these five cases, this improvement would be temporary because the underlying problems continued to jeopardize the viability of the banks.

We also analyzed the relationship between positive outcomes for the bank—both in improving its capital and in correcting the underlying cause of capital problems—and regulators taking more forceful actions.

Of our 72 cases, 22 improved both their capital and the underlying cause of their capital problems. In 15 of these 22 cases, the regulators had taken the most forceful action available under the circumstances. At the other end of the spectrum, 20 banks improved neither their capital nor the underlying causes of capital problems. In 14 of these 20 cases, regulators had chosen not to use stronger enforcement actions available to them.

The strength of this association led us to perform a statistical test to determine whether the relationship could be shown to be statistically significant.[1] We found that it was. That is, better outcomes—in both capital improvement and causes of capital depletion corrected—were associated with the most forceful actions taken. Conversely, worse outcomes were associated with not taking the most forceful actions available.[2]

Regulatory Philosophy and Discretion Promote Use of Less Forceful Actions

The philosophy of all three bank regulators is to work cooperatively with bank managers to resolve safety and soundness concerns. National data show a trend toward informal rather than formal actions, confirming that regulatory practice is consistent with the cooperative philosophy. Our case results also confirmed that regulatory practice is consistent with the cooperative philosophy. We noted that bank regulators relied on capital injections, new bank managers and owners, or their own judgment in lieu of taking more forceful actions available to correct safety and soundness problems.

Regulatory Discretion and Philosophy

As described in chapter 1, regulators have various informal and formal enforcement actions at their disposal to get bank management to address unsafe and unsound practices or conditions identified during bank examinations. The regulators have broad discretion in deciding which, if any, regulatory action to choose. Regulatory guidelines suggest that regulators should consider the willingness of bank management to address the identified problems along with the likelihood of the bank's failure in choosing the forcefulness of the action undertaken.

[1]For reporting purposes, we define a statistically significant relationship at the 5-percent level.

[2]We also found that there was a statistically significant relationship between capital improvement and the most forceful actions taken. We did not, however, find a statistically significant relationship at the 5-percent level between correcting the underlying causes of capital depletion and taking the most forceful actions available. Nevertheless, the direction of the relationship was positive. The probability level for the statistical test was 19 percent.

Each of the three federal bank regulators described to us essentially the same regulatory philosophy guiding the use of their discretion. They prefer to work with cooperative bank managers to bring about necessary corrective action rather than impose formal actions.

OCC officials advised us that OCC consciously decided in the mid-1980s to change its philosophical approach to try to work more cooperatively with bank managers to encourage them to make necessary improvements rather than to impose formal enforcement actions to compel managers to act. While FDIC and FRS officials did not suggest such a conscious decision to change their philosophy, they too expressed a preference for working with cooperative bank management rather than imposing formal enforcement actions. Under this shared philosophy, all three regulators have tended to use informal rather than more contentious formal enforcement actions to encourage cooperative bank managers to deal with problems regulators identified in bank operations.

National Data Show Trend Toward Informal Rather Than Formal Actions

As reflected in table 3.4, regulators' tendencies toward favoring informal over formal actions have become more pronounced in recent years.

Table 3.4: Enforcement Actions Taken by Bank Regulators (1986-1989)

Enforcement Action	Agency	1986	1987	1988	1989
Informal actions					
Commitment letter[a]	OCC	22	109	117	118
MOU	OCC	40	23	10	22
	FDIC	455	413	408	409
Various other actions	FRS[b]	65	70	59	65
Total informal actions		**582**	**615**	**594**	**614**
Formal actions					
Formal/written	OCC	233	87	29	87
agreements	FRS	42	11	19	11
	FDIC[c]	0	0	0	0
C&D	OCC	94	31	25	45
	FRS	25	7	22	1
	FDIC	123	105	98	97
Removal, prohibition,	OCC	38	22	29	14
and suspension order	FRS	5	9	16	5
	FDIC	32	21	33	10
CMP	OCC	197	156	121	129
	FRS	11	3	2	3
	FDIC	14	3	10	9
Total formal actions		**814**	**455**	**404**	**411**

[a]Only OCC uses commitment letters.

[b]Informal actions taken by FRS include MOUs, letter agreements, and board resolutions. A detailed breakout was not readily available.

[c]FDIC uses C&Ds rather than written agreements.

All three federal bank regulators used more formal actions in 1986 than they did in 1989. While the level of bank failures and problem banks remained high between 1986 and 1989, regulators increasingly favored informal enforcement actions during that period. In fact, by 1989, the number of formal actions had decreased over 40 percent from 1986 levels; informal actions exceeded formal by about 150 percent.

Consistent with its conscious philosophical change, the tendency toward informal actions was most pronounced at OCC with a fivefold increase in commitment letters between 1986 and 1989. The combined number of C&Ds and formal written agreements dropped over 56 percent during the period. Its philosophical change was also reflected in a recent OCC publication that reported that some supervisory concerns that previously

would have been handled through enforcement actions were now being handled less formally.[3]

The trend away from formal actions in FDIC and FRS was not accompanied by increased informal actions. Instead, informal actions by FDIC slightly decreased during this period, and they stayed about the same for FRS banks.

Case Analysis Shows Regulators Often Chose a Less Forceful Action Than Those Available

In most of the 38 cases where more forceful actions could have been taken, the actions not taken were formal. C&Ds were, by far, the most frequent of the available actions not taken.

Table 3.5: Stronger Enforcement Actions Available But Not Taken

Type of enforcement action	Number of banks
Informal actions	
Board resolution	1
Commitment letter	1
MOU	7
Formal actions	
Formal/written agreement	6
Capital directive	2
C&D	20
Court enforcement of written agreement or cease and desist order	4
Removal, prohibition, and suspension order	6
Termination of insurance	2
CMP	11

The available actions reflected on this table exceed 38 because, in several instances, regulators could have taken more than one action on a sampled bank. For example, if a bank violated a C&D, regulators are statutorily authorized to proceed with court enforcement of the C&D, to initiate a removal, prohibition, and suspension order, and/or to assess CMPs against responsible bank officials, depending on the situation.

Local regulatory officials, who were responsible for initiating enforcement actions, generally agreed that technically the grounds existed for taking these actions. However, the officials cited what they felt were

[3]Quarterly Journal, Office of the Comptroller of the Currency, March 1990, Vol. 9, No. 1.

overriding considerations for not taking them. These reasons varied widely, but generally reflected regulators' overall philosophy of working with cooperative bank managers to encourage them to take corrective action.

Table 3.6 lists the reasons cited by regulatory officials for choosing less forceful enforcement actions in our 38 sampled cases for which the grounds for more forceful action were evident from the examination files.

Table 3.6: Reasons Regulators Cited for Not Taking More Forceful Actions

	Number of sampled banks whose capital condition		
Reasons cited by category	**Improved**	**Did not improve**	**Total**
Considering capital adequacy			
Recent/anticipated capital infusion	3	11	**14**
Avoid adversely affecting possible merger/acquisition	1	3	**4**
Capital not below minimum	1	3	**4**
Avoid adversely affecting planned stock offering	0	1	**1**
Soliciting bankers' cooperation			
Change in management	4	7	**11**
Board promises or appears to be trying	1	5	**6**
Change in directors	2	2	**4**
Change in ownership	2	2	**4**
Resignation of bank official	0	3	**3**
Exercising regulatory discretion			
Existing action was enough	3	8	**11**
Informal action or moral suasion was enough	3	6	**9**
Deferred to state agency	3	5	**8**
Insufficient evidence	3	5	**8**
Violations or noncompliance with outstanding action not severe enough	3	4	**7**
Not considered	1	2	**3**
Headquarters rejected more forceful action	0	1	**1**

Note: For each bank, regulators may have cited more than one reason for actions not being taken.

The reasons cited for not taking more forceful enforcement actions in these 38 cases were consistent with the regulators' reliance on capital as a measure of a bank's financial health and viability. Regulators clearly did not want to take an enforcement action that they believed would

potentially damage the bank's ability to attract capital through injections, stock offerings, mergers, or acquirers; nor did they want to take action until capital levels fell below minimum standards.

The reasons cited also reflect the regulatory philosophy of working with cooperative bank management. If additional capital was injected or promised or if new managers, owners, or directors entered the picture, regulators tended to give bank management the benefit of the doubt in being willing and able to deal with the problems identified. Not only were changes in managers, directors, or owners cited as reasons not to act more forcefully, but so were board promises or appearances of trying to deal with problems.

Regulators also cited the adequacy of existing actions, the belief that informal actions or moral suasion would work, the deferral to state banking regulators, or the insufficiency of evidence of unsafe and unsound conditions as reasons for not taking more forceful actions. With the discretion that regulators have in the current enforcement process, they do not have to justify the actions taken or not taken unless challenged by their own management or contested by bank management.

Excessive Application of the Cooperative Philosophy

We endorse the concept of a cooperative philosophy up to a point. Regulators and bankers will mutually benefit from a safe and sound banking system. This principle provides incentives for both parties to avoid unnecessary controversy and legal actions by cooperatively resolving safety and soundness concerns. However, if carried too far without obtaining positive results, the cooperative approach can prove damaging over the longer term because underlying problems can become intractable. Thus, there is a point in the regulatory process where increasingly forceful actions need to be brought into play to better ensure positive outcomes. We question whether current regulatory practice extends that point too far.

To illustrate, there were 38 cases in which regulators could have used more forceful actions. We believe that in 37 of these cases they should have done so because

- the underlying causes remained uncorrected and/or
- the bank had a history of noncompliance with existing enforcement actions or a history of repeatedly violating banking regulations.

In the remaining case in which the regulator could have taken more forceful action, we believe it was reasonable that more forceful action was not taken since the underlying cause of the capital depletion was corrected, the bank was complying with the existing enforcement action, and the regulator had not found repeat violations of banking regulations.

Dealing Forcefully When Underlying Cause Goes Uncorrected

We identified 26 of 37 cases in which we believe that stronger enforcement action was available and should have been taken in an effort to get banks to correct the underlying causes of their problems. These 26 cases include 10 where the underlying cause of capital problems was only partially corrected, and 16 cases where the underlying cause of the capital problem was not corrected.

The data in table 3.6 indicate that while the regulators may have relied on external events such as outside capital infusions or new, more effective managers, these events most often did not result in capital improvement. In some instances, anticipated capital injections never materialized, or capital injections, while increasing a bank's ability to sustain losses, did not effectively deal with the serious asset, earnings, and/or management problems that caused the bank's capital problems. Promises to take corrective action through management changes were also no guarantee that effective corrective action would be taken. Further, in many of these sampled banks, regulators had been trying unsuccessfully for extended periods of time to get bank managers and directors to address both capital problems and the causes of capital depletion. Moreover, such a regulatory response to identified bank problems did not always provide banks with an incentive to devise solutions that would effectively deal with both the capital deficiency as well as the underlying causes that led to capital depletion. The following example illustrates how these practices can lead to future capital deficiencies.

An October 1987 examination reflected severe asset problems in a bank stemming from aggressive and liberal lending practices, lending irregularities, and speculative real estate ventures. Although capital exceeded 13 percent, the high level of problem assets coupled with operating losses strained capital. While agency guidelines allowed using an MOU in this situation, regulators opted for a less forceful action—a board resolution—because the bank president had been replaced and the board had initiated corrective action.

The September 1988 examination revealed capital deterioration to a 5.84-percent level. Moreover, assets had grown excessively from $75 million to over $115 million. Besides various regulatory violations, the bank had not fully complied with the board resolution, and regulators found senior management and directors had been ineffective in handling the bank's financial affairs. Regulators initiated a C&D, which included a provision requiring a capital level of 7.5 percent. However, the bank contested the C&D and, as a compromise, agreed to an MOU, including a commitment to raise about $4 million in additional capital by September 1989.

A January 1990 exam found that the bank had not complied with most of the provisions of the 1989 MOU, operating problems still existed, and bank capital was further depleted to 4.83 percent. Only slightly over $2 million in capital had been actually raised. Further straining an already inadequate capital position was continued asset growth with assets nearing $140 million. Although the bank's financial status would have been weaker without the additional capital, the informal actions regulators used to get the bank to address operating problems clearly had not prevented further capital depletion caused by excessive growth and continued lending irregularities.

Dealing Forcefully With Continued Noncompliance

Overall, there were 35 cases out of the 37 where we believe that the bank regulators were not sufficiently forceful in applying regulatory guidelines to banks with a history or pattern of noncompliance. These cases include 11 in which the bank had corrected the underlying causes of capital depletion. A more forceful regulatory action was not taken in the 35 cases even though the banks had (1) not complied with outstanding enforcement actions, (2) repeatedly violated banking regulations, and/or (3) violated regulations governing insider activity. Not taking a more forceful action in such cases appeared to be inconsistent with agency guidelines that call for taking forceful enforcement actions when bank managers have been ineffective at correcting previously identified problems.

For example, bank regulators did not take a more forceful action available in 28 cases where banks had not complied with outstanding enforcement actions. Our analysis showed that on average these 28 banks had been noncompliant with existing enforcement actions for 20 months. In the worst such case, a bank had been noncompliant with a written agreement for 46 months. The regulator, at one point, decided not to issue a C&D to compel the bank to address the identified problems

because the bank anticipated a capital injection, and the existing action was considered sufficient. Over this 46-month period, the capital infusion did not result in the bank meeting required capital levels, the bank had not complied with all provisions of the written agreement, and the regulator had identified repeat violations of various banking regulations.

In another seven cases, regulators did not take a more forceful available supervisory action although the bank had repeatedly violated banking regulations. Such violations standing alone may not have provided a basis for initiating a more forceful regulatory action. However, in our opinion, the nature and repetitiveness of the violations—in combination with other unsafe and unsound practices—provided a basis for more forceful action. Instead, regulators treated these as technical violations.

Regulation O Violations

We were particularly concerned in cases where regulators failed to take a more forceful action when the bank in question had been found to have violated Federal Reserve Regulation O or a similar requirement.[4] This regulation essentially places restrictions on extensions of credit by Federal Reserve member banks to officers, directors, and principal shareholders of the bank and of other related affiliated parties such as the bank holding company and its subsidiaries. These restrictions include loan limits and preclude loans with terms more favorable than those available under market conditions (e.g., interest-free loans). Restrictions also provide for additional safeguards by requiring that insider loans be approved in advance by a majority of the bank's entire board of directors. Intended to safeguard against insider lending abuses, the regulation specifically provides for CMPs against managers or directors, if violated.

We found that regulators had identified Regulation O violations in 36 of the 72 sampled banks. In 23 of these 36 cases, regulators could have taken more forceful action but did not. In each of these 23 cases, other problems existed such as noncompliance with existing enforcement actions or repeat violations of other banking regulations. Further, 11 of the 36 banks had failed to correct the Regulation O violations by the next examination; and in 9 cases, the violations eventually resulted in loans that regulators classified as exhibiting greater than normal risk of

[4]Regulation O applies to FRS. FDIC- and OCC-supervised banks are subject to the same or similar requirements. For example, FDIC-supervised banks are subject to Federal Reserve Act provisions authorizing Regulation O loan limits by a cross-reference in Section 18 of the Federal Deposit Insurance Act.

nonpayment. While these violations were reflected in the examination reports along with discussions of applying more forceful actions, CMPs were only assessed in one case solely on the basis of the Regulation O violations.

The following example illustrates the potential impact of Regulation O violations on a bank's financial condition and the importance of effective enforcement action to protect against such adverse impacts.

A bank had a history of Regulation O violations beginning in 1986, with continued violations found in three consecutive examinations up to 1989. The violations consisted of loans to directors, the Chief Executive Officer, and other senior bank managers that provided favorable terms, exceeded lending limits, or were extended without required board approval. Despite the regulator's repeated warnings, the bank failed to correct the violations. Moreover, it continued to violate the regulation after informing regulators in 1987 that procedures had been instituted to prevent recurrences. Regulators had classified nearly $500,000 of the bank's loans that were in violation of Regulation O as exhibiting higher than normal risk of nonpayment.

According to the regulator's guidelines, CMPs would have been in order, particularly in light of the pattern of repeat violations. Officials told us, however, that CMPs were not pursued in this case because the violations did not appear abusive or represent significant loss to the bank. However, regulators subsequently attributed the bank's failure later in 1989 to, among other reasons, unsafe lending practices.

Enforcement Process Needs Better Focus and More Certainty

Given our case results, we believe that there are opportunities to further improve the effectiveness of the bank supervisory process. Only 22 of 72 cases fully improved their capital condition and the underlying causes for capital concerns during the multi-year time frame we analyzed. When more forceful supervisory actions were taken, the bank was more likely to improve its capital condition. Similarly, banks whose capital position was unimproved more frequently had not been subject to the more forceful enforcement actions that were available. While we cannot conclusively show that the regulators would have achieved better outcomes in these cases by using more forceful actions, we believe that the supervisory process could benefit from a better focus through industrywide measures, and greater certainty regarding the regulatory responses to violations of those measures.

More Clear-Cut Measures for Unsafe and Unsound Practices

The focus for the current enforcement process, as well as for many reform proposals, is on capital and a bank's ability to satisfy minimum capital standards. In fact, the only standards or industrywide measures contained in banking regulations to guide regulators in making enforcement distinctions are the capital standards. This places the focus for enforcement on a valid but lagging factor of the safety and soundness of a bank's operations rather than on the factors that lead to capital depletion.

Each bank regulator has internal guidance, including some quantifiable measures, for its examiners to identify problems and weaknesses in each component of bank operations—assets, earnings, management and liquidity. However, these measures are not always identical among regulators. More importantly, since official industrywide measures have not been established, the supervisory process is made more difficult given the lack of certainty faced by both the regulators and bankers.

In addition to capital, we believe that having clear-cut measures available for other CAMEL components would help regulators and bankers focus on unsafe and unsound banking practices in all bank components, including those that indicate problems earlier than capital depletion. Such measures could also guide the enforcement process to better assure that appropriately forceful actions are taken to remedy problems as they become evident.

Enforcement Actions Not Specifically Tied to Unsafe and Unsound Practices

There is little certainty in the current enforcement process as to which, if any, enforcement action should be taken by regulators to get banks to address specific problems identified in bank operations. Even when capital standards are not met by banks in which regulators have previously found serious problems in bank operations, regulators are not required to choose among formal enforcement actions but have the discretion to decide which, if any, available action—informal or formal—they consider to be most appropriate.

Our sample cases show that this discretion has not always proven to be effective for resolving safety and soundness concerns raised by regulators. We believe that a better alternative would be to establish a series of increasingly stringent enforcement actions corresponding to an increasing severity of unsafe and unsound practices or conditions.

How More Certainty Could Be Introduced Into the Enforcement Process

Our proposal for strengthening the bank enforcement process envisions a tripwire system of measures and accompanying regulatory responses being categorized into phases of intervention that become increasingly more severe as a bank's condition deteriorates. Such phases might include (1) problems involving internal or management controls over banking operations which have not yet resulted in high levels of nonperforming assets or operating losses; (2) problems in assets, earnings, management, or liquidity that have not yet impacted bank capital; (3) problems in bank operations that have impacted capital and deterioration has caused the bank to fall below minimum capital standards; and (4) problems that have depleted bank capital. The following illustration describes how the enforcement process could be altered to (1) develop a series of measures to standardize definitions of unsafe and unsound practices within a CAMEL component and (2) tie specific enforcement actions to such measures.

Regulators presently gauge asset quality during examinations using internal measures, like the ratio of nonperforming assets to capital. A series of established measures and regulatory responses might look like the following:

- An industrywide ratio, say 100 percent for discussion purposes, could be established through regulation as a threshold for poor asset quality. A banker would know that exceeding 100 percent would violate that measure and could plan a strategy to either sell or call problem assets to ensure that this asset quality measure is met.
- If the measure was not met, the regulator would require the bank to make necessary improvements to its lending and underwriting practices and better manage its loan collection activities within a specified period of time. These requirements would also be accompanied by limits on asset growth and interest rates offered to attract deposits, as well as a requirement for higher than minimum capital levels.
- Should the bank be unable to take the required corrective actions within the specified time, such as raising its capital to specified levels within 6 months, the regulator would be required to recommend that FDIC, as the bank insurer, raise the bank's insurance premiums to reflect the additional risk reflected in its operations.
- Should the nonperforming asset ratio further deteriorate to 150 percent, the regulator would then be expected to further restrict the bank's limits on funding through brokered deposits, as well as limit the flow of funds out of the bank through dividends or payments to affiliates.

- Should the asset deterioration cause the bank's capital to be depleted to or below required levels, the regulator would be required to place further growth and cash flow restrictions on bank management, possibly including requiring changes in managers or directors. The regulator would also be required to proceed with a break-up analysis of the bank if capital levels cannot be restored within specific time frames, and determine whether to place the bank in conservatorship.
- Regulators would be permitted to deviate from the specific actions but would be required to document such deviations. In cases of national and Federal Reserve member banks, the regulator would be required to report those deviations to FDIC so that, from an insurer's perspective, an adjustment to the insurance premium may be considered based on the additional risk the bank condition poses to the insurance fund.

This enhanced enforcement process would reduce—but not remove—regulators' discretion so that regulatory choices for responding to problems identified during examination would be understood throughout the industry. Under such an enhanced enforcement process, bank managers, directors, and owners would be better able to anticipate the supervisory consequences of engaging in activities that jeopardize their ability to meet established measures. This would also enhance their ability to voluntarily take preventive action to avoid being compelled by the regulator or insurer to take corrective action.

Conclusions

We believe that the considerable discretion in the use of enforcement actions and the extensive use of the cooperative approach we observed in our sampled cases has been detrimental to the enforcement process. We also believe that to further reduce the exposure of the industry and insurance fund to losses from bank failures, regulators need to better focus their attention on problems that lead to capital depletion.

In our opinion, Congress should require bank regulators to establish by regulation a tripwire system including (1) industrywide measures of assets, earnings, and management to signal problems that, if not corrected, will lead to capital depletion, and (2) the appropriate regulatory enforcement actions to be taken when a bank is unable or unwilling to satisfy these industrywide measures. Through this system, the mandate for more forceful regulatory action will be clear.

Recommendations

The specifics of the enhanced enforcement process we envision are contained in our recently issued report, Deposit Insurance: A Strategy For Reform (GAO/GGD-91-26, Mar. 4, 1991).

Comments From the Federal Deposit Insurance Corporation

FDIC generally agreed with our conclusions, particularly about the need for regulators to intervene earlier and more vigorously when bank problems are identified and to focus to a much greater extent than they now do on the underlying causes of capital depletion. FDIC also agreed that there is a need for more definitive standards for unsafe or unsound practices that apply to measures other than capital. However, FDIC expressed the concern that our tripwire approach to enforcement would unnecessarily reduce the amount of flexibility regulators have in designing enforcement strategies to get improvement. FDIC believed that better results could be achieved through enhanced enforcement guidelines and through fostering a climate that is more vigilant.

GAO's Response

We believe our tripwire approach to the enforcement process would be effective precisely because it would reduce—but not remove—the discretion present in the current system. Our work clearly demonstrates the need for a reduction of this discretion. Currently, there is considerable uncertainty in the industry about which specific practices regarding assets, earnings, or management may be regarded by regulators as unsafe or unsound. The enforcement process can only be helped by introducing more definitive measures regarding unsafe and unsound practices and linking regulatory responses to those measures so that bankers, regulators, and others know much more precisely what to expect from the enforcement process. We believe that these changes can best be achieved in the framework of our tripwire approach.

Comments From the Federal Reserve System

FRS basically agreed with our conclusions about the need for regulators to take earlier prompt corrective actions when bank problems are identified. FRS agreed to consider whether measures of asset quality and earnings could be incorporated into a framework of more prompt corrective actions. However, FRS questioned the appropriateness of increasing the use of formal actions as opposed to informal actions. FRS believed that increased use of formal actions could lead to an increase in the adversarial nature of the banker/regulator relationship.

GAO's Response

Our results show that both bankers and regulators would benefit from the use of more forceful actions more quickly. In some cases, the stronger actions could be informal. For example, we had instances in our sample of banks where regulators identified problems but took no action. In some of these cases, we believe the regulators should have taken an informal action, such as an MOU, to get bank management to better focus on the problems identified. In the long run, it may be that our tripwire approach results in regulators taking more formal actions than under the current enforcement process. However, we do not believe this would necessarily result in a more adversarial relationship between bankers and regulators. Since regulatory responses would be specifically tied to measures of assets, earnings, management, or capital, all parties would benefit from having the same expectations about performance on these bank components. Thus, bank managers would know specifically when their actions will trigger a regulatory response. Under these circumstances, we believe the adversarial nature of the banker/regulator relationship may actually be mitigated.

Comments From the Office of the Comptroller of the Currency

OCC said they shared our interest in ensuring the bank regulatory agencies' enforcement responses are as effective and efficient as possible. OCC remained open to discussions of enhancements to the enforcement process. OCC specifically agreed with our point about the importance of capital as well as those practices and conditions that deplete capital. OCC also agreed with the need for action like that described in our fourth tripwire requiring conservatorship, merger, acquisition, or liquidation when a bank's equity capital is exhausted.

OCC, however, had concerns about three aspects of the report: (1) the feasibility or practicality of developing quantitative measures for CAMEL components beyond capital, (2) whether our methodology provided an adequate basis for drawing conclusions about the enforcement process, and (3) the discussion and characterization of OCC's enforcement policy as being relaxed during the 1980s.

GAO's Response

OCC's study on failed banks also showed that bank management was a key factor in determining whether a problem bank recovers or ultimately becomes insolvent. Consequently, OCC recognized the importance of addressing factors other than capital in bank supervision and enforcement. OCC has also published a rule which changed its policy to require a bank to be declared insolvent when equity capital is extinguished. OCC said they were familiar with our proposed tripwire

approach and was willing to explore alternative approaches to bank enforcement.

OCC's concerns about our tripwire approach to the enforcement process involved the feasibility or practicality of establishing quantitative measures for all CAMEL components and the need for maintaining flexibility and discretion in the process. As OCC pointed out in its March 18, 1991, letter, bank regulators already have general guidance for qualitative assessments for use in assigning the CAMEL component ratings. OCC also cited the existence of well-recognized industry measures of performance that provide guidance to both bankers and regulators. Nevertheless, OCC suggested that developing industrywide measures for components, such as management quality, would be a very difficult task.

We do not suggest that developing industrywide measures for all bank components accompanied by prescribed enforcement actions that can be agreed upon by all three bank regulators and the banking industry would be an easy task. However, as OCC pointed out, bank regulators already have internal measures that are used for assigning CAMEL ratings. We are not suggesting that all measures must be quantitative. Indeed, deficiencies involving poor management or internal controls, for example, cannot always be quantified, but in our view qualitative measures can certainly still be developed.

We are willing to work with Congress and the regulators as they establish a framework for a tripwire approach to bank enforcement so that regulations can be established to advise all affected parties—bankers, regulators, and others—as to the regulatory response that can be expected when the industrywide measures are not met. The regulatory measures and responses would not eliminate regulators' discretion in deciding what, if any, action to take in specific circumstances. They would, however, considerably reduce the discretion and require regulators to justify and document any deviations from the prescribed regulatory responses.

With regard to OCC's concerns that our methodology did not provide an adequate or valid basis for drawing conclusions about the enforcement process, we believe our methodology provided a valid basis for assessing the enforcement process as it applies to banks that regulators have identified as having capital problems. Our study was designed to randomly sample banks with identified capital problems from all three federal bank regulators in three geographic locations. While our sample size was

initially not thought to be large enough to allow us to statistically project or generalize our results, officials from all three banking regulators advised us that our randomly selected cases would be indicative of what we would be likely to find in any location with regard to the use of enforcement actions on banks with capital problems.

In assessing our results from the sampled cases, we were struck by the difference in outcomes—capital improvements and underlying causes corrected—when the most forceful available actions were taken as opposed to when they were not. We tested the associations between the outcomes and the actions taken and found them to be statistically significant. The statistical associations between better outcomes and forceful actions taken and worse outcomes and forceful actions not taken show a high likelihood that, if we were to take and analyze other random samples from the same universe of capital-deficient banks, we would get essentially the same results. Although other factors may be relevant, the focus of our statistical analysis was on how the use of enforcement actions affected bank improvements. With the statistical significance, we believe our results are not only indicative of what we would find in other capital-deficient banks, but could be generalized to the effectiveness of the enforcement process in dealing with the universe of banks with capital problems from which we sampled our 72 cases.

OCC pointed out that our statistical methodology did not provide a basis for direct inferences about the effectiveness of the supervisory process in correcting problems that arise in banks that have adequate capital. Since we sampled only banks with capital problems, this observation is technically correct. It is possible that some adequately capitalized banks overcame management problems as a result of informal supervisory actions, just as it is likely that some banks corrected such problems without any external intervention at all. Our statistical study focused on banks that had fallen into more serious difficulty.

Our results showed no significant differences among the regulators in how they used available enforcement actions to get banks to address identified capital problems or the underlying causes of capital depletion. We concluded that the comparability of our results among the regulators was due, for the most part, to the considerable discretion available to them combined with a shared philosophy of working with cooperative bank management. The only significant differences found among the regulators was in the use of enforcement actions over the last several years—the national statistics showed a decline in the use of formal

enforcement actions by OCC. While OCC did not agree with our characterization of its enforcement policy, the national statistics, OCC officials' description of a conscious change in philosophy, and our review of randomly selected OCC examination histories were consistent with each other and with our characterization of OCC's enforcement practices. OCC described its policy as requiring enforcement action to be taken when serious violations exist involving insider abuse, failure to cooperate with regulators, or failure of previous actions to address identified problems. We found OCC's practices, however, to be inconsistent with this policy. We found these types of serious violations in 11 of the 24 sampled cases that OCC regulated, yet more forceful available actions were not taken. More specific guidance is apparently needed for OCC regulators—guidance which we believe could best be provided through our tripwire approach to the bank enforcement process.

Comments From the Federal Deposit Insurance Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Division of Supervision

March 11, 1991

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to review and comment on your draft report, Bank Supervision: Better Focus and Greater Certainty Would Enhance Enforcement Effectiveness.

FDIC staff has reviewed the report and agrees generally with most of the conclusions. We also agree with the basic finding of the report, namely, that bank supervision can and should be improved. We believe, nevertheless, that some observations are pertinent with respect to certain key elements of the report.

See comment 1.

The report asserts that capital is a "lagging indicator" of soundness and that more attention must be paid to the underlying problems leading to capital depletion. In our view, unsound practices and capital dissipation tend to run hand-in-hand so that the apparent "lag" in capital as an indicator is only because capital measures are taken less frequently and at discrete times, particularly after lump sum charges are made to capital. Consequently, we would caution against regarding capital as a "lagging indicator" which could lead to inappropriate judgments or unwarranted conclusions.

We fully agree, however, that supervision must focus to a much greater extent on resolving underlying problems without regard necessarily to the current level of capital in an institution. We sense what may be an unfortunate tendency in supervision to delay forceful action to curtail or eliminate unsound practices so long as an institution is amply or, even in some cases, merely adequately capitalized. In some sense, this may be premised on the desire to accord management considerable discretion in managing an institution without governmental intrusion, particularly when risking stockholders' funds. Experience has demonstrated, however, that all too often available capital can be dissipated very rapidly, exposing depositors (and hence the FDIC and taxpayers) to considerable risk and loss. Consequently, we agree that there must be a renewed emphasis placed on stopping promptly unsafe practices per se before they materially impact capital and without regard to what may be the level of capital in an institution at the time.

See comment 2.

We agree as well on the need for more definitive standards regarding unsafe or unsound practices and overall performance dimensions. Such standards would serve to introduce a greater degree of consistency in supervision and protect the insurance fund as banks become aware of those standards and attempt to conform their conduct accordingly. However, establishing standards is not a new concept. The regulators have been establishing safety standards as an ongoing process over the years. However, a better organized, more comprehensive, consistent and concerted effort is needed, particularly with respect to lending standards which, during much of the past decade, deteriorated and gave rise to considerable excesses. While advocating more definitive standards, however, there is a need as well to avoid overly constraining institutions in a manner that would prevent them from performing their proper function in our economy and earning a fair return for their owners in the process. The trick is to find the proper balance and apply the standards consistently and yet with enough flexibility to allow for legitimate differences in circumstances.

See comment 3.

The point and means of agency intervention are fundamental to the supervisory process. What should be done and when is always a judgment call and seldom clear or simple. Such judgments cannot be fairly assessed by subsequent results alone. Nevertheless, we agree generally that the agencies need to intervene earlier and more vigorously in most situations and not permit unwarranted delays in addressing significant safety and soundness concerns or violations. We do not believe, however, that this supervisory process readily admits to a "trip wire" approach. Typically, institutions experiencing financial and managerial difficulties present a complex set of variables in a fluid and constantly evolving set of circumstances. The regulators must assess these situations, select among the enforcement options available and decide what is reasonably achievable and at what cost. Moreover, no course of action, whether a cooperative approach or the most forceful formal action possible in the circumstances, necessarily guarantees success. The most difficult part of the process is not making requests or issuing formal orders but obtaining compliance with those requests or orders since compliance must be accomplished by the ownership and management of an institution in any event. For example, it is one thing to require additional capital but it is quite another for management to raise or otherwise restore capital within some reasonable time frame. Similarly, it is one thing to constrain or seek the removal of a marginal or incompetent officier, by whatever means, but it is quite another to find a more suitable replacement.

See comment 4.

We continue to believe that the degree of cooperation evidenced by management and its willingness to effect necessary changes is an important consideration in choosing the most appropriate enforcement option. More formalized enforcement actions always involve additional costs, both in terms of resource allocations and delays, particularly when institutions or other respondents choose to avail themselves of their due process rights to a notice of charges, a hearing, etc. All such factors must be considered in fashioning the most appropriate supervisory response in a given set of circumstances. This process of choosing the supervisory response to effect necessary changes in an institution's condition and operations is an ongoing one and necessarily involves considerable judgment and flexibility. It does not admit to an automatic or mechanical approach that may often produce unanticipated,

unnecessary or unwanted results and at considerable additional cost.

See comment 3.

While we do not believe that a "trip wire" approach is workable in supervision, we fully agree that the regulators must be more forceful in addressing unsafe and unsound practices and violations of law. This is best accomplished, in our view, by developing appropriate enforcement guidelines and fostering a supervisory culture and practice that is more vigilant, less tolerant of any continuation of unsafe or unsound practices or violations and more inclined to resort earlier to more formalized enforcement means.

See comment 5.

While we cannot support the "trip wire" approach in the supervisory process, we believe there is room for such an approach in the regulatory area. For example, we could support such measures as denying institutions the opportunity to grow, or to pay dividends or extraordinary executive compensation as soon as they became undercapitalized. Such measures could prove very useful to both the regulators and the regulated institutions by establishing some additional ground rules designed to promote safety and soundness and protect the insurance fund without the contention, cost and delay that often results from addressing such issues on an ad hoc case-by-case basis.

Enclosed is a copy of your report marked-up with possible technical changes or corrections. These are offered for your consideration in preparing the final version of your report.

Sincerely,

John W. Stone
Associate Director

Enclosure

The following are GAO's comments on the Federal Deposit Insurance Corporation's (FDIC) March 11, 1991, letter.

GAO Comments

1. We agree with FDIC that unsound practices and capital dissipation are directly related. While the apparent lag in capital may in part be due to the timing of the measurement of capital, we believe it is primarily due to the fact that other underlying problems usually precede and are at the root of capital problems. In our sampled banks, problems in assets, earnings, and bank management were clearly evident for at least a year prior to the time regulators identified capital problems. Logically, erosion of bank capital generally occurs after decreases in bank earnings, which occur after losses from problem or nonperforming assets. Further, problems in assets and earnings often arise as a reflection of management problems or deficiencies.

2. We recognize that the bank regulatory agencies have established, over the years, internal measures of bank performance, particularly in the areas of assets and earnings. However, these measures are not recognized industrywide, nor are poor performances of these measures defined in regulation as "unsafe practices." Thus, there is considerable uncertainty in the industry about which specific practices regarding assets, earnings, or management, for example, may be regarded by regulators as unsafe or unsound. We believe that more definitive measures regarding unsafe and unsound practices, which FDIC acknowledges are needed, can best be achieved in the framework of our tripwire approach to enforcement; that is, the use of specific industrywide measures tied to specific regulatory responses.

3. One of the major points in our report is that the considerable discretion available to bank regulators coupled with their tendency to work with cooperative bank management are the major reasons the regulators do not intervene sooner and more forcefully than they should. While we are not advocating removal of the regulator's discretion from the bank enforcement process, we remain convinced that our work demonstrates the need to reduce that discretion. This reduced discretion also gives notice to regulators, bankers, and others affected by the enforcement process as to what enforcement response to expect if industrywide measures are not met. If bank management is unwilling or unable to address the bank's problems and conditions further deteriorate, regulators would be compelled to take increasingly more stringent enforcement actions. After all, the regulators have responsibilities to ensure the stability of the banking industry and the bank insurance fund, along with

the safe and sound operations of banks they examine. Under our tripwire approach, regulators would be required to take one of several possible actions should a tripwire be activated. Where regulators declined to take enforcement actions linked to one of the tripwires, they would be required to document the reasons for their decision.

4. We believe that it is appropriate to consider the cooperativeness of bank management—up to a point—when considering implementing enforcement actions. However, in our 72 sampled banks, we identified 35 cases where bank regulators opted to use an informal approach working with "cooperative" bank management to try to resolve bank problems even where management had failed to comply with existing enforcement actions, where regulators had identified repeated violations of banking laws and regulations, or where regulators had identified the involvement of bankers in insider activity violations. We agree that no specific course of action necessarily guarantees success. However, the seriousness of these failures of bank management to correct problems should have clearly signaled to the regulators that their informal approach to working with "cooperative managers" was not effective and that more forceful actions were in order.

We believe that implementing our tripwire approach, which will require earlier and more forceful intervention, will not impose significant additional cost or resource burdens on the bank regulators. Because, in the long run, this approach will likely result in more prompt correction of bank problems, and hence, perhaps a reduction of the number of enforcement actions that need to be taken, we believe costs may actually be less than under the current system. However, if additional costs or delays are encountered, we believe there are remedies for reducing them. For example, since our tripwire approach would reduce enforcement discretion, it may be feasible for the bank regulators to devolve approval from their headquarters to field offices for all but the most severe formal enforcement actions.

5. FDIC supports the concept of imposing additional measures, such as restrictions on growth, as soon as banks become undercapitalized. As our report clearly shows, waiting until banks become undercapitalized to impose more forceful actions is not an effective enforcement strategy. By taking earlier forceful action to correct asset, earnings, or management problems before they begin to affect capital levels, the regulators will in many cases be able to avoid the more severe actions that become necessary when bank capital deteriorates below required levels or is depleted.

Comments From the Board of Governors of the Federal Reserve System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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

DIVISION OF BANKING
SUPERVISION AND REGULATION

March 11, 1991

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Fogel:

I am responding to your letter of March 1, 1991 to Chairman Greenspan requesting comment on the General Accounting Office's draft report on the effectiveness of federal bank regulators enforcement activities. The comments of the Board staff are enclosed.

Sincerely,

Frederick M. Struble
Associate Director

Enc.

Comments of the Staff of the Federal Reserve Board
on the
General Accounting Office's Report to the Congress
on the
Effectiveness of Federal Bank Regulators
Enforcement Actions

A basic conclusion reached by the GAO in this study is that the bank supervisory process can be greatly improved. That improvement can be achieved, GAO recommends, by the Congress mandating the establishment of a regulatory system of "tripwires" that would specify regulatory actions to be taken by depository supervisors, in a prompt and forceful way, in response to unsafe and unsound banking practices and conditions -- the actions to become more stringent as problems become more serious. This "tripwire" system is recommended for two major reasons: it would provide assurance that regulators will take appropriate and effective supervisory actions in a timely way; and, it would put bank managers and boards of directors on notice, with greater certainty than at present, that supervisors will take decisive, known actions when unsafe and unsound conditions are identified, thereby giving greater incentives to operate institutions in a prudent manner.

The "tripwire" system is essentially similar in basic concept to the "prompt corrective actions" framework recommended by the U.S. Treasury in its recent report to the Congress concerned with the financial deposit insurance system and related matters. Moreover, the reasons offered by the Treasury to support its recommendation are basically the same as those set down by the GAO for its "tripwire" system.

See comment 1.

The Federal Reserve is already on record as being generally supportive of the "prompt corrective actions" framework proposed by the Treasury. In short then, the Federal Reserve is in agreement with the GAO on the "basics" of what should be done to improve the supervisory process. While a consensus on "basics" appears to exist, however, there are differences in certain of the details of the "tripwire" and "prompt corrective actions" proposals. These differences require elaboration.

Presentations of the "prompt corrective actions" framework have, to date, focused exclusively on the capital positions of institutions in specifying conditions that are to trigger one of a range of regulatory actions. The GAO believes this exclusive focus is an important deficiency, because it found in its study that a change in capital position is a lagging indicator of an institution's problems. Capital declines, the GAO concluded, because of prior shortcomings of management and deterioration of asset quality that cause earnings to turn negative. Accordingly, the GAO incorporated into its "tripwire" proposal the requirement that regulators should develop industry-wide standards for these "leading" variables and focus on them as well as on capital measures to trigger supervisory actions.

The difference in variables specified to trigger supervisory action is, in the Federal Reserve's view, to a considerable degree the result of emphasis in presentation of the proposals rather than in the substance of their expected

execution. Prompt corrective action is perhaps best understood as an important complement to, rather than a substitute for, traditional supervisory policies and procedures. If the framework is adopted, the Federal Reserve would still intend to continue, in both its off-site surveillance and on-site examinations, to review all key aspects of an organization's condition and practices that are summarized by the acronym, CAMEL -- i.e., capital, asset quality, management, earnings, and liquidity. Deficiencies and shortcomings in any of these areas would be addressed promptly and as effectively as possible.

If that is the case, however, the question remains: why not develop industry-wide standards for components of CAMEL in addition to capital and focus pre-specified corrective actions on them as well? No generally accepted quantitative measure for management is readily available to serve as the basis for a standard and, given the subjective nature of judgments that must be made in assessing management, there is an obvious reason to question whether such a measure can be developed. That is not the case with regard to asset quality and earnings, however. Regulators have long classified assets and referred to measures of total and weighted classified assets in gaging the overall quality of an organization's assets. And earnings or income, of course, are traditional quantitative measures of the performance of an institution.

In considering the advisability of incorporating quantitative measures for these variables, however, it is well to keep in mind that accounting methodology now requires that

See comment 2.

changes in either, if severe enough, will be reflected in capital positions in the same accounting period. Specifically, a deterioration in asset quality is supposed to result in an immediate provisioning for potential losses resulting therefrom and thus impact earnings and, if sufficiently great to cause negative earnings, capital too. The provisioning, moreover, if accurately performed, is supposed to be sufficient to account for the full potential impact of the asset quality problems on earnings and capital.

How then to account for the GAO's finding that capital is a lagging indicator? The answer is that there is considerable uncertainty surrounding the provisioning process, uncertainty as to how individual borrowers will perform on their loans and, more importantly, uncertainty as to how underlying economic conditions will change and affect the ability of borrowers to perform. In Texas and New England, for example, conditions in the economies of these regions and most particularly in their commercial real estate markets deteriorated well beyond early expectations so that heavy provisioning for loan losses was required in accounting periods subsequent to the onset of problems with consequent impacts on earnings and capital.

Adoption of annual examinations with full scope asset review and more frequent examinations of troubled institutions by all supervisors are important elements embodied in both the "tripwire" and "prompt corrective actions" proposals. These supervisory activities should help promote provisioning for

potential loan losses by organizations that is as accurate as possible to achieve under conditions of uncertainty. Moreover, the agencies have in process, through the auspices of the Federal Financial Institutions Examination Council, a review of methodology for assessing loan loss reserves. These measures together with the aforementioned intention of the agencies to continue to assess all aspects of an institution's practices and conditions should serve to assure that corrective actions will be taken to address promptly all identified deficiencies within a framework focused on capital. However, it is our intention to also consider whether measures of asset quality and earnings might be incorporated more explicitly into the prompt corrective actions framework, as the GAO has recommended.

See comment 3.

The prompt corrective action proposal, as it has been presented to date, has focused on prescribing actions and measures that supervisors should require institutions to take (or be constrained from taking) and has been silent on the means to be used by supervisors to see that these orders are complied with. GAO has concluded from its study that in the past supervisors have not been as effective as they might have been in getting institutions to take appropriate corrective measures, because they relied too greatly on informal rather than formal enforcement actions. GAO thus recommends that, going forward, much greater use should be made of formal actions.

Formal enforcement actions have an important advantage over informal actions in that banks realize that failure to comply with them can result in civil money penalties and other

See comment 4.

See comment 5.

regulatory penalties. At the same time, formal actions have important disadvantages. They generally involve more work and thus greater costs for both the supervisors and subject organizations, are more likely to be challenged by subject organizations because of the potentially more serious consequences of noncompliance, and, for the same reason, are more likely to create an adversarial relationship that can impair the ability of supervisors to carry out their fact-finding duties. Taking those points into account, there is good basis for using informal actions when an institution's problems are not too severe and management appears inclined to be cooperative. Cooperation, moreover, can be expected in situations in which the actions and measures prescribed by the supervisor are in the best interests of an organization's management, board of directors and stockholders. When such situations are not present, however, and/or management does not appear inclined to be cooperative -- a judgment perhaps based on past experience -- then, formal actions would appear to be the better approach.

Situations vary along a continuum between the two types just described, and there is, then, a question as to where to draw the line between formal and informal actions. The finding of the GAO that in its sample of problem banks formal actions proved more effective indicates the advisability of carefully reviewing existing policies and practices to see whether a shift toward greater use of formal actions should be instituted. We intend to carry out such a review.

The following are GAO's comments on the Board of Governors of the Federal Reserve System's (FRS) March 11, 1991, letter.

GAO Comments

1. Our tripwire approach is fundamentally different from the Treasury proposal in that we suggest four tripwires that could be activated based on increasingly severe problems in management, assets, earnings, as well as capital. The Treasury proposal focuses only on capital as the trigger for prompt enforcement action.

2. We are convinced that the three bank regulators—FRS, Office of the Comptroller of the Currency (OCC), and FDIC—working together can develop a set of measures for assets, earnings, and management that are tied to specific regulatory responses. As the FRS response indicates, the bank regulatory agencies have established, over the years, some measures of bank performance, particularly in the areas of assets and earnings. Further, we are not suggesting that all measures of bank performance, such as management deficiencies, need to be quantitative. Indeed, findings involving poor internal controls, for example, cannot always be quantified, but in our view standards or other qualitative measures can still be developed. The important point is that current measures are not recognized industrywide, nor are poor performances on these measures defined in regulation as "unsafe practices." Thus, there is considerable uncertainty in the industry about which specific practices regarding assets, earnings, or management, for example, may be regarded by regulators as unsafe or unsound. We believe that our tripwire approach to enforcement—the use of specific industrywide measures tied to specific regulatory responses—will clarify expectations about performance on these key indicators for bank management, the regulators, Congress, and the public.

3. Our position is that both bankers and regulators would benefit from the use of more forceful actions more quickly. In some cases, the more forceful actions we envision would be informal. For example, there were instances in our sample of banks where regulators identified problems but took no action. In some of these cases, we believe the regulators should have taken an informal action, such as a memorandum of understanding (MOU), to get bank management to better focus on the problems identified.

4. In the long run, it may be that our tripwire approach results in regulators taking more formal actions than under the current approach to enforcement. However, we do not believe this will necessarily result in a

more adversarial relationship between bankers and regulators or be more costly or time-consuming. Since regulatory responses would be specifically tied to measures of assets, earnings, or management, all parties would benefit from having the same expectations about the performance on these dimensions. Thus, bank managers would know specifically when their actions would trigger a regulatory response. Under these circumstances, we believe the adversarial nature of the banker/regulator relationship may actually be mitigated. Also, because our approach would likely result in more prompt correction of bank problems and, hence, perhaps a reduction of the number of enforcement actions that need to be taken, we believe costs may actually be less than under the current system. However, if additional costs or delays are encountered, we believe there are remedies for reducing them. For example, since our tripwire approach would reduce regulatory discretion, it may be feasible for the bank regulators to devolve approval from their headquarters to field offices for all but the most severe enforcement actions.

5. As we stated in our response to FDIC's comments, we believe that it is appropriate to consider the cooperativeness of bank management—up to a point—when considering implementing enforcement actions. However, in our 72 sampled banks, we identified 35 cases where bank regulators opted to use an informal approach working with "cooperative" bank management to try to resolve bank problems even where management had failed to comply with already existing enforcement actions, where regulators had identified repeated violations of banking laws and regulations, or where regulators had identified the involvement of bankers in insider activity violations. We agree that no specific course of action necessarily guarantees success. However, we believe the seriousness of these failures of bank management to correct problems should have clearly signaled to the regulators that their informal approach to working with "cooperative managers" was not working and that more forceful actions were in order.

Comments From the Office of the Comptroller of the Currency

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

March 18, 1991

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Re: Draft Report on Bank Supervision

Dear Mr. Fogel:

Thank you for the opportunity to review the above-referenced report. We share the GAO's interest in ensuring that the bank regulatory agencies enforcement responses are as effective and efficient as possible, and as always, we remain open to discussion of enhancements to that process.

The GAO report makes a number of important points with which the OCC agrees. Two deserve special mention. First, as the GAO points out, while capital is an important factor in assessing a bank's condition, other factors also play a significant role in maintaining a bank's financial health.

For example, the OCC's study of failed banks found that bank management is often the key factor in determining whether a problem bank recovers or ultimately becomes insolvent. The OCC's supervision policy requires that these other factors be specifically addressed in bank supervision and examinations, including enforcement actions when necessary.

Second, the OCC strongly agrees with the criterion set forth in the GAO's fourth "tripwire" requiring either conservatorship or a declaration of insolvency when a bank's equity capital is exhausted. In fact, the OCC formally adopted this criterion in December 1989 when it published a rule under which the OCC declares banks insolvent when their equity capital is extinguished.

In addition to these general comments, however, the OCC has a number of concerns about three aspects of the report. First, we are concerned about the overall methodology used in reaching the conclusions found in the report. Most of the conclusions drawn in the report concerning the effectiveness of enforcement

processes of the federal bank regulatory agencies were apparently based on limited, and in some respects, flawed statistical analysis.

Second, we are concerned about the discussion and characterization of OCC's enforcement policy. The report erroneously concludes that OCC enforcement policy was relaxed during the 1980s. While the policy was modified to permit a more efficient and flexible enforcement response that included consideration of the degree of cooperation evidenced in a given situation, cooperation was only one of a number of factors to be considered. In fact, the policy retained its basic thrust and direction of requiring an effective, efficient and vigorous enforcement response.

Finally, we are very concerned about the feasibility or practicality of attempting to develop quantitative standards for the measurement of components of the CAMEL ratings other than capital, i.e., management, assets, earnings or liquidity. Set out below is a more detailed discussion of these issues.

I. Report Methodology & Conclusions[1]

A. Methodology

See comment 1.

Most of the conclusions drawn in the report concerning the effectiveness of agency enforcement actions are drawn on the basis of the statistical analysis performed on the 72 selected banks reviewed for the report. The report bases its analysis on a sample of undercapitalized institutions -- not on a sample of institutions that received formal or informal supervisory actions. These are often two distinct universes of institutions. By reviewing only undercapitalized banks, the study automatically excludes institutions that responded positively to informal supervisory action and quickly corrected management problems. By so doing, these institutions avoided a serious depletion in capital and remained above required capital minimums. The sample selection process therefore prohibits the report from reaching reliable conclusions on the general effectiveness of informal supervisory actions.

See comment 2.

Moreover, the limited number of institutions included in the report raises questions concerning the significance of many of the conclusions drawn in the report. The report itself (Chapter 1 - page 12) acknowledges that "we did not review a sufficient number of banks to allow us to generalize our observations across the nation, each location or each agency..." This

[1] Also attached to this letter is a brief listing of some technical changes which are intended to enhance the accuracy and completeness of the report.

acknowledgement suggests that some caution should be used when considering or adopting certain of the findings or recommendations which are based in substantial part on statistics drawn from this limited sample. We do not believe the conclusions reflect the necessary degree of caution.

B. Conclusions

1. Forceful Actions & Results

See comment 2.

The report draws the conclusion that "better outcomes were associated with the most forceful actions taken." Given the limited statistical sample presented in the study, we question whether it is possible to conclusively find a cause and effect relationship on the basis of this single factor in the context of this highly complex environment. Any number of factors (both internal and external) can and do have an effect on whether or when a bank recovers from its problems. Access to capital markets, degree of cooperation and commitment on the part of bank management and the directorate, the level of capital at the time examined, and the condition of the economy in which the bank operates are all factors that can have an impact on whether a bank recovers from its problems.

See comment 3.

GAO correctly notes, and OCC's experience has been that timing of a supervisory response is very important. However, we have also found that an early supervisory response using less formal supervisory tools can be and often has been more effective than a severe response taken late in the process.

See comment 4.

The report's conclusion that more forceful or severe enforcement actions should always be favored is flawed. This conclusion presupposes (1) that more formal action would always be legally permissible, and/or (2) that a less severe form of action will always be less effective. The table on Page 15 of Chapter 1 of the report demonstrates the diversity and complexity presented by this selection of enforcement cases. The reasons given in this table for not taking more forceful action in these cases range from concerns about legal sufficiency to a belief that the level of action chosen would be the most effective under the circumstances. The validity of the reason cited in each one of these cases can only be assessed in the context of the individual case.

See comment 5.

For example, it does not necessarily follow in every case that non-compliance with an outstanding action should conclusively lead to a more severe action. The reasons for non-compliance need to be considered, as well as the ability of the bank to achieve compliance under any form of document. If a bank that is under a commitment letter is doing everything possible to achieve and maintain a specified capital level, but is simply unable to do so, placing the bank under a more severe document will not

alter that reality. If, on the other hand, cooperation is lacking or the bank has failed to do those things that can and reasonably should be done, a more severe response would be entirely appropriate. In fact, this latter situation is one of the circumstances addressed in OCC's enforcement policy which specifically calls for more severe action.

Any supervisory enforcement scheme will no doubt contain isolated instances where the process ultimately proved inadequate under the circumstances, or where established agency policies were not closely followed. The fact that such instances occasionally occur, however, should not automatically lead to a conclusion that the process or policy is inherently flawed.

2. "Reluctance" to Take Action

See comment 6.

At a number of points in the report, the conclusion is offered that "Regulators clearly did not want to take enforcement action that they believed would potentially damage the bank's ability to attract capital through injections, stock offerings, mergers, or acquirors; nor did they want to take action until capital levels fell below minimum standards."

This is simply untrue with respect to OCC enforcement practice. It has been consistent OCC policy to take enforcement actions whenever justified and needed. It is certainly possible that OCC might decide not to take enforcement action in a given case if it felt that the bank's problems would be better addressed through injections of capital or changes in ownership or management. However, OCC would not permit the potential "chilling" effect of an enforcement action to prevent the agency from taking that action if it were in fact needed.

3. Focus on Capital Only

See comment 7.

The report states that agency enforcement actions "focused primarily on correcting capital problems rather than the underlying causes of capital depletion." At the OCC, enforcement actions are very comprehensive in their scope. OCC enforcement documents routinely address any and all areas of a bank's operations criticized in the examination process. While capital is frequently of direct concern, enforcement actions often address management, loan policies, liquidity and violations of law as well. In fact, a common "complaint" received regarding OCC's enforcement actions is that they are too comprehensive in their scope and breadth.

II. OCC's Enforcement Policy

The report refers to OCC's change in its enforcement philosophy in the mid 1980s and characterizes that change as one focusing on working more cooperatively with bankers. This is certainly true

as far as it goes, but it is important to note that consideration of the degree of cooperation was only one of a number of revisions in OCC's enforcement policy.

See comment 8.

OCC's policy is intended to allow some flexibility, so that enforcement decisions can take into account the individual circumstances of each bank. Instead of relying entirely on numerical indicators, the policy relies on a variety of considerations in deciding whether to take enforcement action. It is important to note that the policy also specifically identifies three areas in which the OCC presumes that enforcement action is appropriate. These involve the presence of serious violations, instances of insider abuse, and instances where previous actions have not been effective or the OCC is not receiving the cooperation of the institution.

See comment 9.

OCC's enforcement policy has been vigorously applied throughout the 1980s. OCC's 1990 report of enforcement actions filed with Congress earlier this year, showed a total of 842 formal and informal enforcement actions initiated in a single year. This number included 163 civil money penalties. The GAO's report reflects that the OCC takes many more formal actions per regulated bank than either the FDIC or the Federal Reserve Board.

Having said this, it is important to recognize that in the final analysis it is not the number of actions taken or even the type of actions taken that should be the measure of success in assessing the effectiveness of an agency's enforcement process. Rather, it is the accomplishment of the supervisory goals in light of the facts and circumstances in each case.

III. Measures of Safety and Soundness

See comment 10.

The report recommends adoption of a series of quantitative measures of safety and soundness for management quality, asset quality, liquidity and earnings -- similar to those now used in the capital adequacy area.

The current industry-wide accounting standards that have led to uniform methods for measuring capital have evolved over the last sixty years. The development of industry-wide standards to measure other areas of concern such as management quality would likely be a very difficult task. There is already much general guidance in these areas to help examiners make the qualitative assessments that go into a CAMEL rating. Comprehensive regulations, interpretative rulings, written policies, advisories, and well-recognized industry measures of performance are available to provide guidance to both bankers and regulators. However, none of these have proven amenable to being reduced to purely quantitative measures. That is why the agencies have relied on the qualitative assessments by the examiners.

See comment 11.

While OCC is willing to explore alternative approaches to making our enforcement decisions, we should move cautiously before replacing our current case by case approach. Whatever system is used must retain sufficient flexibility and discretion to address changing circumstances. The flexibility and discretion provided by the current enforcement process, initiated on a case by case basis within the guidelines of a well-crafted enforcement policy should not be completely lost in the process of correcting existing deficiencies.

Conclusion

We appreciate the opportunity to provide our perspective in responding to you on issues of mutual concern. The GAO has made some excellent points about the need for bank supervision, including enforcement actions, to focus on a wide range of factors that affect a bank's financial health.

Sincerely,

Robert L. Clarke
Comptroller of the Currency

Attachment
Additional Technical Comments:

A. Executive Summary

Change made - see p. 2.

Page 2 (1st Paragraph): It is not the enforcement process that identifies unsafe and unsound banking practices; it is the process of bank supervision and examination. Enforcement is one of many responses available when problems are identified in the course of bank supervision.

Added - see p. 3.

Page 4: The listing of formal actions at the top of this page should include Formal Agreements.

B. Report - Chapter 1

Change made - see pp. 18-19.

Page 6: The report indicates that "regulatory concerns are brought to a bank's attention through meetings with bank management upon completion of the examination." At the OCC, regulatory concerns are identified and discussed with bank management throughout the course of the examination. Examiners conduct an exit meeting, followed by a Board of Directors meeting, to formally communicate examination results.

See comment 12.

Page 8: The discussion near the end of this page, in order to be more complete, should also note that substantial civil money penalties may be sought for violations of formal enforcement documents. With respect to actions taken in the district courts, it should also be noted that once an action is filed in district court, non-compliance with court-ordered enforcement could lead to contempt citations and judicially-levied fines as well.

Change made -see p. 20.

Page 9: The report states that "Written Agreements--which, while formal, are not made public like C&Ds." Up until the passage of the Crime Control Act of 1990 on November 29, 1990, this was a true statement. However, that Act now mandates that formal written agreements be made public in the same manner as C&Ds.

The following are GAO's comments on the Office of the Comptroller of the Currency's March 18, 1991, letter.

GAO Comments

1. Our methodology for this study was specifically designed to determine how effectively federal bank regulators use available enforcement actions to get bank management to address identified capital problems and the underlying causes of capital depletion. We therefore randomly selected a sample of banks that regulators identified as having capital problems as of January 1, 1988. This random selection of 72 banks with capital problems was evenly divided among the three regulators and three geographic locations. We discussed our methodology with the three regulators, including OCC officials, who agreed that whatever we found in the randomly selected cases would be indicative of what we would find in other banks with capital problems. In fact, our results showed little difference among regulators or locations in how enforcement actions are used in addressing capital problems or their underlying causes.

Our approach was not designed specifically to assess the effectiveness of informal or formal enforcement actions. However, we did trace the examination histories of the randomly selected cases to determine when capital became a regulatory concern, what caused the capital problem, and what actions were taken to address the problems identified. Since we found that capital was a lagging indicator of other unsafe or unsound practices or conditions in bank operations, we frequently reviewed several years of examination reports prior to January 1, 1988. We also traced these examination histories through September 30, 1990, to determine what enforcement actions were available, those taken, and the effectiveness of actions taken. We believe this extensive review of 72 randomly selected cases gives us a valid basis on which to draw conclusions about the effectiveness of the regulatory enforcement process as it is applied to banks with capital problems.

2. Our sample size, 72 randomly selected banks out of a universe of 1,494 capital-deficient banks in three geographic locations, was not initially believed to be large enough to allow us to statistically project or generalize our results over the universe of capital-deficient banks, each regulatory agency, or each location. However, in analyzing the results of these sampled cases, we were struck with the difference in the outcomes of cases in which the strongest available actions were taken and those where such actions were available but were not taken. In 15 of the 22 banks where the most forceful available actions were taken, the banks

were able to improve their capital condition and correct the causes of their capital depletion. Conversely, in 14 of the 20 banks where the most forceful available actions were not taken, the banks did not improve their capital condition, nor did they correct the causes of capital depletion.

With the difference in the results of our 72 sampled cases, we used statistical tests and found a statistically significant association between the outcomes of those cases where the most forceful available action was taken and improvement in capital condition. We have amended the discussion in our report to reflect the fact that the sample results did permit us to generalize to the locations from which we sampled. The statistical tests that we performed do not demonstrate a cause and effect relationship between outcomes and actions; instead, they show that there is an association between the outcomes and the actions that would be highly likely to be replicated if other random samples were taken and analyzed. Although other factors may be relevant, the focus of our analysis was on how the use of enforcement actions affected bank improvements. From our analysis, we believe the better outcomes occurred most frequently when the most forceful available actions were taken, and worse outcomes occurred most often when available enforcement actions were not taken.

We agree that bank regulators operate in a highly complex environment in which any number of factors have an effect on a bank's ability to address its problems. In fact, in our sampled cases, regulators identified numerous factors to which they attributed a bank's problems. In our tripwire approach to the bank regulatory process, regulators would consider all relevant factors in determining the bank's condition and could deviate from the prescribed enforcement actions but would have to justify, document, and approve any deviations.

3. We share OCC's view about the importance of regulators taking early enforcement action to get banks to address problems before they adversely affect bank capital, earnings, or assets. We also agree that the prescribed enforcement actions when problems are initially identified—our tripwire 1--need not be severe if the bank shows a willingness and ability to address the identified problems. We believe, however, that as bank problems become more severe, so should the forcefulness of the enforcement actions. Therefore, the enforcement actions prescribed in our tripwires 2, 3, and 4 would become increasingly more forceful.

4. We concluded that the regulatory enforcement process needs to be improved to achieve better results, that regulatory discretion and philosophy have resulted in available enforcement actions not being taken, and that better outcomes have been achieved when the most forceful available actions were taken. We are not suggesting that regulators must take forceful actions when problems in banking operations are first identified, nor are we suggesting that only the strongest actions will get bank management to address identified problems. Instead, our proposed tripwire system calls for regulatory responses commensurate with the severity of bank problems identified. As we describe in the report, the reasons regulators gave us for not taking an available action appear to have some validity when viewed in isolation. However, when these reasons are considered in the context of a bank whose conditions are not improving, and whose officials are not complying with existing enforcement actions or who are repeatedly violating banking regulations, they do not appear to provide a valid basis for deferring more severe enforcement actions. While we agree that each case must be assessed on its own merits, we strongly disagree that valid conclusions cannot be reached through the consolidation of analyses of randomly selected cases.

5. In the OCC example, we agree that a more severe action may not be appropriate. Under our tripwire approach, the regulator would only need to justify and document any deviation from prescribed enforcement actions. However, this example is not typical of what we found in the sampled cases. Bank management usually agreed with the regulatory actions taken, but upon further analysis we found that bank conditions further deteriorated, and/or there was noncompliance with the enforcement actions or banking regulations. Consequently, we believe bank management's professed cooperation was not reflected in its responsiveness to the problems regulators identified. While regulators' policies do provide for taking more severe enforcement actions when a bank is not adhering to the existing actions, we found that these policies were generally not being followed. These instances were neither occasional nor isolated in our sampled cases but instead were evident in many of the 37 cases in which we concluded that more forceful actions should have been taken.

6. We found that all three federal bank regulators favored working with cooperative bank management and relying on capital injections rather than taking more forceful enforcement actions. While OCC policy may be to take enforcement action whenever justified and needed, we found that, in practice, OCC frequently did not take forceful actions when the grounds for such actions were evident. In fact, 11 of the 37 cases in

which we believe more forceful actions should have been taken involved banks regulated by OCC. Our concern is that enforcement actions being taken by regulators are not commensurate with the severity of the bank conditions identified during examinations. Our proposed tripwire approach would link increasingly more stringent enforcement actions with deteriorating bank conditions.

7. We agree that enforcement actions taken by regulators include provisions that are intended to address all the problems identified with bank practices or conditions. The actions taken by the regulators that we reviewed tended to be extensive lists of provisions to address problems in assets, earnings, management, and capital without necessarily establishing priorities for these provisions. While these actions were usually quite comprehensive, we found they were frequently not taken until capital was adversely affected. Regulators typically reported problems in assets, earnings, or management along with the potential adverse affects on capital in examination reports at least a year before enforcement actions were taken. Until capital was adversely affected, regulators were all too often reluctant to take forceful enforcement actions to get banks to address the underlying causes of capital depletion. Our tripwire approach would compel regulators to take prescribed actions when the problems in bank practices or conditions are identified rather than waiting until capital is affected.

8. Our review of OCC cases, discussions with OCC officials, and our analysis of national statistics on enforcement actions all support our conclusion that OCC, along with the other bank regulators, has considerable discretion in deciding what, if any, action to take. OCC said that its policy requires appropriate enforcement actions to be taken in instances of serious violations involving insider abuse, failure to cooperate with regulators, or failure of previous actions to address identified problems. We found, however, that OCC practice was not consistent with this policy. In fact, OCC did not take available enforcement actions in 11 of the 24 cases in our sample for which it was responsible. We based our conclusions about the need for enforcement actions in these cases on precisely the same types of violations that OCC cited in its policy.

9. Our review of national enforcement data showed that the OCC enforcement practices resulted in a decline in the use of formal enforcement actions during the 1980s. We did not compare the proportion of actions taken relative to the number of banks supervised by regulator. We believe that our analysis of enforcement data along with case reviews shows that all three regulators, however many actions they took, were

not taking the early and forceful actions we believe necessary to correct bank problems before they affected capital. Only 22 of the 72 sampled banks both improved their capital levels and addressed the underlying causes of capital problems. In 15 of these cases regulators had taken the strongest actions available to them. These results indicate that the enforcement process needs to be more effective to protect the stability of the banking industry and the Bank Insurance Fund.

10. From our review, we are aware of various qualitative and quantitative measures of bank practices and conditions that are available to bank regulators through internal agency guidance. These measures are currently used by regulators in assessing each component of bank operations and assigning CAMEL ratings at the conclusion of bank examinations. We believe the federal bank regulators, along with the banking industry, need to agree on precise measures for each component to be established in banking regulations. The regulations also need to include corresponding enforcement actions that would be activated when the measures indicate safety and soundness problems. We agree that establishing quantitative measures and corresponding actions for the management component may be the most difficult; however, we believe industry standards and other qualitative measures can be developed for assessing the quality of such factors as management and internal controls. Industrywide measures for the management component are, in our view, critical if unsafe or unsound banking practices are to be corrected before they affect assets, earnings, or capital.

11. We are willing to work with Congress and the regulatory agencies as they establish the framework for our proposed tripwire approach. We do not believe our proposed tripwire approach would eliminate regulators' discretion; it would only reduce it. Regulators could deviate from the prescribed actions as long as they justify and document the reasons for such deviations. This reduction in discretion would be accompanied by an increase in the predictability of regulatory response so that bankers, regulators, and others would know with much greater certainty what to expect from the regulatory process.

12. We agree that noncompliance with court-ordered enforcement actions can result in contempt citations or fines. However, in order for these penalties to be asserted, the regulator would have to advise the court of the noncompliance. These penalties are an extension of court-ordered enforcement of regulators' enforcement actions and cannot be asserted by the regulators.

Profiles of Sampled Banks With Capital Problems

Midwest banks accounted for 14 of the 23 banks with agricultural-related asset problems. Southwest and western banks were more affected by real-estate-related asset problems. Of the 33 banks with real estate asset problems, 16 were Southwest banks, and 13 were western banks.

Table IV.1: Types of Problem Assets by Region

	Banks with problem assets			
Type of problem asset	**Chicago**	**Dallas**	**San Francisco**	**Total**
Real-estate-related loans	4	16	13	**33**
Other real estate owned	9	9	8	**26**
Agricultural loans	14	5	4	**23**
Commercial and industrial loans	8	7	7	**22**
Participation loans	0	6	1	**7**

Southwest banks made up 20 of the 43 banks with lax or liberal lending practices. Southwest banks also accounted for most (17) of the 40 banks affected by a depressed economy. Of the 21 banks that had not adhered to established policies and procedures, 10 were in the Midwest. Western banks accounted for most (14) of the 20 banks with asset problems due to lending violations.

Table IV.2: Major Reasons for Asset Problems by Region

	Banks with problem assets			
Reason cited by regulators	**Chicago**	**Dallas**	**San Francisco**	**Total**
Inadequate bank underwriting policies and procedures	15	19	23	**57**
Liberal/lax lending practices	13	20	10	**43**
Depressed local economy	12	17	11	**40**
Nonadherence to established bank policies and procedures	10	4	7	**21**
Violations of lending laws/ regulations	4	2	14	**20**
Lack of diversification	2	3	8	**13**
Insider abuse or fraud	1	3	4	**8**
Overreliance on out-of-territory lending	1	2	3	**6**

Analysis of Sampled Banks With Capital Problems

We did not identify significant differences among the bank regulators or the 3 locations for the 38 cases in which banks were able to improve their capital condition. We also did not identify significant differences among the 3 regulators for the 34 cases in which banks did not improve their capital condition. However, the Southwest banks accounted for 13 of the banks that did not improve their capital condition.

Table V.1: Attributes of Sampled Banks That Improved Their Capital Position

Bank number	Formal action before 1/88	Formal action after 1/88	Informal action before 1/88	Informal action after 1/88	Available enforcement actions not taken	Underlying problems corrected	Did not comply with prior enforcement action	Repeat violations found	Violated Reg. O
1	X				Y	Y	X	X	
2	X				Y	Y		X	X
3	X				Y	Y	X		
4	X				Y	Y	X	X	
5					Y	Y		X	
6	X				N	Y	X	X	X
7					N	Y		X	X
8	X			X	Y	Y		X	X
9					Y	Y			
10	X				N	Y	X	X	X
11	X				Y	Y		X	
12	X				N	Y	X		X
13	X				N	Y	X	X	
14	X				Y	Y		X	
15	X	X			N	Y	X	X	
16	X			X	Y	Y	X		
17				X	Y	Y	X		X
18			X	X	Y	Y	X		
19	X				N	Y	X	X	
20	X				Y	Y			
21					Y	Y	X		
22					Y	Y		X	X
23					Y	P			X
24	X				Y	P	X		
25				X	Y	P	X		
26					N	P		X	
27	X				Y	P	X		
28					Y	P		X	X
29	X				N	P	X	X	X

(continued)

Bank number	Formal action before 1/88	Formal action after 1/88	Informal action before 1/88	Informal action after 1/88	Available enforcement actions not taken	Underlying problems corrected	Did not comply with prior enforcement action	Repeat violations found	Violated Reg. O
30			X	X	N	P		X	
31					N	P	X	X	X
32	X				Y	P		X	
33					Y	N		X	X
34	X				Y	N	X	X	X
35					N	N			
36		X	X		Y	N	X	X	X
37		X			Y	N	X	X	X
38				X	N	N		X	X

LEGEND:

Y=Yes

N=No

P=Partial

Table V.2: Attributes of the Sampled Banks That Did Not Improve Their Capital Position

Bank number	Formal action before 1/88	Formal action after 1/88	Informal action before 1/88	Informal action after 1/88	Available enforcement actions not taken	Underlying problems corrected	Did not comply with prior enforcement action	Repeat violations found	Violated Reg. O
1			X		N	Y	X	X	X
2	X				Y	Y			
3	X				N	Y	X		X
4		X	X		N	Y	X	X	X
5	X				N	Y	X	X	X
6			X	X	Y	Y	X	X	
7	X			X	Y	Y	X	X	
8				X	N	Y			
9	X				N	P	X	X	X
10	X				N	P	X	X	
11	X				N	P	X	X	X
12	X		X	X	N	P	X	X	X
13		X			N	P			
14	X	X			Y	P	X	X	
15	X				N	N	X	X	X
16					N	N		X	X
17	X				N	N	X		
18			X	X	N	N	X	X	
19	X	X			N	N	X	X	X
20		X	X		N	N	X	X	X
21	X				N	N	X	X	X
22	X			X	Y	N	X		
23		X			Y	N		X	
24		X			Y	N	X	X	X
25	X				Y	N	X	X	
26		X	X		N	N	X	X	X
27					N	N		X	
28	X	X			N	N	X	X	X
29		X			N	N		X	
30	X				N	N	X		
31				X	Y	N	X	X	X

(continued)

Bank number	Formal action before 1/88	Formal action after 1/88	Informal action before 1/88	Informal action after 1/88	Available enforcement actions not taken	Underlying problems corrected	Did not comply with prior enforcement action	Repeat violations found	Violated Reg. O
32		X			N	N	X	X	X
33				X	N	N	X	X	X
34	X	X			Y	N	X	X	X

LEGEND:

Y=Corrected
N=Not corrected
P=Partly corrected

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