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Prompt Corrective Action Provisions: Are Insurance Companies and Investment Banks Next?

In 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA). The Act aimed to recapitalize once and for all the depository insurance schemes for banks and savings and loan institutions. It also provided for risk-based deposit insurance premiums, put explicit limits on the application of a “too big to fail” principle for banks and required that examiners implement “prompt corrective action” (PCA) standards for banks. Essentially these steps were to improve the functioning of the FDIC, especially removing discretion of the examiners in the process of addressing the risk of failure of banks and providing explicit requirements of managing the deteriorating risk of failure and providing for rising insurance premiums for such banks. In particular, PCA established a set of capital benchmarks and required regulator actions that removed privileges for banks to manage their capital and payments of income to shareholders and bank creditors as the capital position of the bank deteriorated and the risk of failure rose. In effect, regulators could take preemptive action to keep banks from depleting their capital as their capital positions deteriorate.

These provisions have drawn increasing public attention in the past year for very different reasons. First, Senate Bill 40, The National Insurance Act (NIA), which provides new opportunities for insurance companies to obtain their charters and to be regulated by a federal government entity instead of only the state governments, also requires that the new federal regulator develop and apply prompt corrective action

provisions to the supervision of federally chartered insurance companies. The NIA allows insurance companies to have an “optional federal charter” (OFC), so that they may choose their regulator, keeping their charter and regulatory control by state government institution(s) or choosing the federal regulator. In that sense, insurance would join banks, thrift institutions, and credit unions in having access to a dual chartering regime in which they could choose the level of government at which they wish to be regulated. Perhaps not surprisingly, the NIA explicitly requires that the new federal regulator apply PCA to the insurance companies they regulate, just as federal bank regulators must apply PCA to banks.

The second reason that these provisions have drawn attention recently is the near failure and sale of Bear Stearns. The Federal Reserve helped arrange the sale of Bear Stearns in March 2008, with the sale to be completed shortly, to preempt its failure and consequent effects on other financial institutions. At about the same time, the U.S. Department of Treasury released its long awaited “Blueprint for a Modernized Federal Financial Regulatory Structure” that calls for the Board of Governors of the Federal Reserve System to have broad regulatory power over all financial institutions on issues related to financial market stability. These actions call attention to the absence of regulatory oversight powers by the Fed, in particular, enabling legislation that would allow the Fed to close investment banks or other failed or failing institutions in the same way that they can or must close such banks.

The near failure and subsequent nationalization of Northern Rock, a mid-sized bank in England, raised similar concerns as British regulators do not have the same closure abilities or mandates as exist in the United States, nor do they have PCA provisions that could have preempted the failure of Northern Rock.

What is Prompt Corrective Action?

Prompt corrective action (PCA) is a system of regulatory steps that can or must be taken if a bank's capital falls short of certain prescribed benchmarks. The aim is to increase pressure on a bank to take actions to insure that it will not fail because its capital gets too low to avoid bankruptcy. PCA introduced a reliance on the Tier 1 leverage ratio, the ratio of Tier 1 capital to total assets, in classifying banks. Ignoring risk-based capital requirements, the banks are classified as:

- “well capitalized,” if its ratio exceeds 5 percent,
- “adequately capitalized” if its ratio is 4 percent to 5 percent,
- “undercapitalized” if its leverage ratio is 3 percent to 4 percent,
- “significantly undercapitalized if its leverage ratio is 2 to 3 percent, and
- “critically undercapitalized” if its leverage ratio is below 2 percent.

Tier 1 capital includes common stockholder equity, non-cumulative perpetual preferred stock and minority interests in the equity accounts of consolidated subsidiaries.

The leverage ratio criteria and PCA requirements supplement the risk-based capital requirements introduced by the Basel accords in 1988. Table 1 provides the broader

classification framework for PCA. See Spong (2000) or Benston and Kaufman (1997) for more detailed discussions of capital requirements and prompt corrective action.

As a bank's leverage ratio falls from well capitalized to lower levels, regulators impose restrictions on distributions of funds that can be used to boost capital and they can or must require more substantial actions. For example, under PCA, issuing brokered deposits or underwriting securities are viewed as privileges that are removed if a bank falls to the adequately capitalized level. If the capital ratio falls to the undercapitalized zone, the bank must develop and submit a capital restoration plan to regulators, it must restrict asset growth and it must secure regulatory approval before opening new branches or new lines of business. When the leverage ratio falls further to the "severely undercapitalized" level, the bank cannot pay interest above its peer group average as determined by the regulator, and finally, when the leverage ratio falls below 2 percent, steps must be taken to close the bank. Clearly, an effort is made to insure that banks do not close with any liability for the FDIC to cover insured deposits, though failures usually come quickly at the end and it is hard to keep a bank with a 2 percent ratio from deteriorating to negative equity in a very short period of time before it can be closed.

Prompt corrective action's reliance on the leverage ratio is a departure from the risk-based capital standards adopted under Basel I, the international agreement on capital standards established in 1988 or updated in Basel II. Those capital standards attempt to attune the required capital held by banks to the risk of assets. They require the use, at least by large banks, of an internal ratings-based approach to assessing credit risk.

Reliance on a leverage ratio is regarded as crude by proponents of the Basel accords because the interpretation of a given leverage ratio is not adjusted for the risk of the total assets of the bank. Thus a 5 percent ratio of capital to assets is huge if the assets are very safe government securities and is much smaller relative to risk if all of a bank's assets are commercial and industrial loans. The major advantage of PCA is that the leverage ratio it introduced as a capital standard is simple and transparent to investors, customers and regulators alike, but it also has the advantage that it implies a generally higher level of capital than Basel I or Basel II risk-based capital requirements. Vaughan (2008) notes that Basel I was introduced at about the same time (implemented by the end of 1992) as prompt corrective action so that improved capital positions of banks may not have been due to PCA. Gilbert (2006) has shown that most banks, especially large ones, are more constrained by the leverage ratio than they are by risk-based measures, so that being well-capitalized usually requires a higher level of capital than risk-based measures alone.

Risk-Based Capital Requirements

Because of concerns over bank failure and differences in capital standards across the developed world, developed country central banks created the Basel Committee on Capital Standards in the 1980s. This group developed the Basel I standards, grew into the Financial Stability Forum and developed Basel II standards. Because of the capital losses credit crisis and financial sector failures in 2007-08, there is talk of a Basel III. The central idea of the Basel accords is to standardize capital requirements and to recognize the risk sensitivity of the appropriate amount of capital. Basel requires two sets of requirements for Tier 1 capital and total capital, with both measured relative to risk-

weighted assets. The concept of risk-weighted assets is a measure of bank assets that accounts for the fact that some bank assets are very risky and that others are not. Thus standard assets such as commercial and industrial loans are the riskiest and have a weight of 100 percent, but other assets, such as loans to governments or their agencies or marketable government securities, are less risky in terms of the risks of default (credit risk) or market price fluctuations (market risk) so that these assets have less weight in measuring risky assets. The biggest problem with Basel I was that there were few risk categories for differently weighted assets and also banks found it easy to arbitrage the capital requirements by moving risky assets off the books or disguising them as safer assets while loading up on the safer assets on their balance sheets. Banks were also able to use guarantees, collateral, netting arrangements and credit derivatives to alter the risk assessment of risky assets. Thus banks were able to game the system.

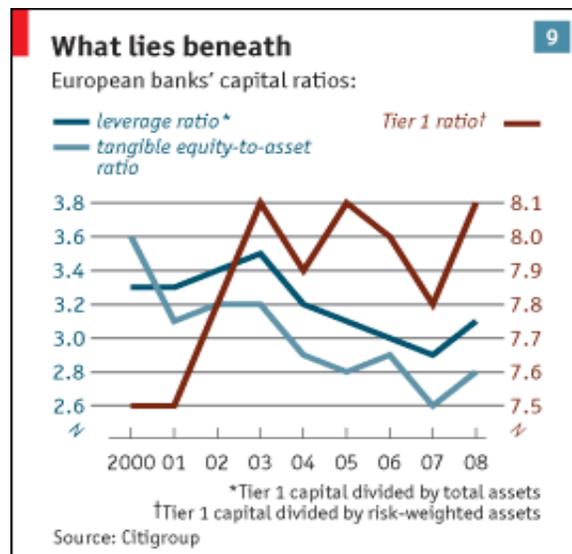
Basel II attempted to provide more pillars for adequate capital standards. It is based on the recognition that large international banks and some others had developed very good international rating systems that allowed them to have much better measurements and assessments of risk, as well as more sophisticated systems for controlling risk. The banks own “internal ratings system” were judged to be more likely to reflect the appropriate risk weights for various bank assets and Basel II provided for banks to be able to use these weights instead of externally generated and imposed weights, though smaller banks were able to develop risk weighted asset measures based on such external measures. To protect against internal abuse, Basel II provided two other pillars to serve as checks on bank measures. The second pillar is regulatory bank supervision which will review internal

methods and provide assessments of the internal methods, and the third pillar is market discipline, the external assessment of the bank's risk by the marketplace, especially in pricing the bank's stock and its marketable debt. Basel II is just beginning to go into use in Europe and will do so in the United States in 2009. Thus it is too early to assess how the new standards will work. The most important point is that Congress and regulators are unlikely to allow U.S. capital requirements to fall dramatically as a result of Basel II implementation, no matter how low risk-weighted assets are relative to total assets.

The chart, taken from the *Economist* magazine of May 15, 2008 and based on Citigroup data, shows that European banks' risk-based capital ratios have bordered on being adequately capitalized under the U.S. standard for risk-based Tier 1 capital from 2001-03.

Chart

European banks are poorly capitalized by U.S. PCA standards



Source: "Cycle clips," *Economist* Magazine, May 15, 2008

However, the leverage ratio shows that the average bank has been undercapitalized since 2000 and the status has been deteriorating throughout the period. In 2007 the ratio indicated that the average bank was significantly undercapitalized using the U.S. leverage ratio classification system for PCA.

Table 1 shows how both standards are used in the United States to define how well capitalized a bank is; thus the average European bank would be classified as undercapitalized from 2000 to 2006 and significantly so in 2007, but this is not the case under risk-based measures. Kaufman (2006) and Kane (2006) argue that PCA's leverage ratio provides a more effective and simpler way to set prudential safety standards than Basel II or risk based measures generally. Vaughan (2008), however, suggests that risk-based capital requirements, at least as drawn up in model legislation used by the National Association of Insurance Commissioners, provide an adequate substitute for prompt corrective action provisions. The latter are called for in the National Insurance Act. Risk-based capital measures in banking and insurance were developed to provide a higher prudential standard of capital management to avoid failure. But Basel requirements, in the absence of PCA, do not impose mandatory restrictions on regulators and, in the case of insurance, it is optional for state regulators to adopt and also optional for the provisions to be implemented. More importantly, it is a guideline for classification with no direct teeth for enforcement or motivation.

In the case of insurance, required reporting is annual, while it is quarterly for banks.

Since capital can be depleted quickly at the end of the life of a failing institution, more

frequent monitoring is vital. As Vaughan (2008, p.8) notes, what she refers to as insurance PCA “is less specific about the nature of regulatory action that must be taken and does not contain specific limitations on insurer activities at different capital levels.” Most important, banks find value in being “well capitalized”; PCA requirements for this classification are more difficult and costly to achieve and usually force institutions to maintain a higher overall capital cushion than do the risk-based requirements [see Gilbert (2006)]. In turn this has meant that U.S. banks have been more immune to failure since the adoption of PCA.

Well capitalized banks benefit by having higher stock market valuations for given earnings, a lower cost of capital and a higher capital cushion when there are credit losses and earnings shocks, as they have had since mid-2007. While increased bank failures are expected from recent credit market events, the numbers are expected to be smaller because of higher capital ratios going into the crisis. Most banks today are well capitalized and hold higher capital than they would without PCA standards. These higher ratios are also making raising new capital easier and less costly.

Prospects for Other Financial Institutions

Setting federal standards for capital requirements at investment banks and insurance companies is on the horizon. Fed interest in the stability of investment banks and perhaps even hedge funds is a likely result of expanded federal regulatory powers of the Fed and their perceived interest in the financial viability of these firms. Similarly federal regulatory provision of prompt corrective action standards for nationally chartered

insurance companies is likely if the National Insurance Act creates a federal role in chartering and regulation of insurance companies. Not only will both efforts require new capital requirement standards, but some coordination with existing or new schemes for insurance of firms' liabilities will be necessary. In addition new statutes or rules for closure, merger or liquidation will be necessary to minimize the exposure of insurance funds, whether federal or not, to failure of these institutions.

Table 1
Criteria for Classifying Banks as Adequately and Well Capitalized

Capital Classification	Risk-based capital ratios			PCA measure	
	Total capital as a percentage of risk-weighted assets		Tier 1 capital as a percentage of risk-weighted assets		Leverage ratio (Tier 1 capital/ total assets)
Well capitalized	10 percent or greater	AND	6 percent or greater	AND	5 percent or greater
Adequately capitalized	8 percent or greater	AND	4 percent or greater	AND	4 percent or greater
Undercapitalized	Less than 8 percent	OR	Less than 4 percent	OR	3 percent to 4 percent
Significantly undercapitalized	Less than 6 percent	OR	Less than 3 percent	OR	Less than 3 percent
Critically undercapitalized	NA		NA		Less than 2 percent*

A *well capitalized* bank must also be free of any directive from its supervisor to maintain a specific capital level.

*Ratio of tangible capital to total assets.

Source: Gilbert (2006) and Spong (2000).

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