Original Article

Failing prompt corrective action

Gillian G.H. Garcia
was an assistant professor at the University of California at Berkeley until she went to Washington to work on the US banking and thrift crises of the 1980s and early 1990s. In Washington, she worked for the US General Accountability Office and the Senate Banking Committee, where she participated in the enactment of reform legislation (the Financial Institutions Reform Recovery and Enforcement Act (FIRREA), and the FDIC Improvement Act (FIDICIA)). She then went to the IMF to help resolve the financial crises in East Asia and advise the fund on issues relating to deposit insurance. She has also been a distinguished professorial lecturer at Georgetown University, a National Fellow at the Hoover Institute at Stanford University, a Visiting Scholar at the Office of the Comptroller of the Currency, the Congressional Research Service, at the Federal Reserve Bank of Chicago, and at De Nederlandsche Bank in Amsterdam. Now retired, she currently teaches from time to time at the University of Maryland, consults for international financial institutions and developing countries and the Financial Services Volunteer Corp, and writes and presents papers on financial sector policy issues. She has published six books and a number of articles – especially on deposit insurance and banking reform for the United States and the EU.

Correspondence: Gillian G.H. Garcia, 4507 Highland Green Court, Alexandria, Virginia 22312-3132, USA

ABSTRACT The prompt corrective action (PCA) provisions of the 1991 Federal Deposit Insurance Improvement Act were enacted to deter future financial crises and to minimize losses to the Federal Deposit Insurance Corporation (FDIC). They have failed to do so. To determine why the article examines 50 material loss reviews made available online from 2007 through 2009 by the inspectors general of the federal banking agencies. The reviews find that small and medium-sized banks failed not by participating in new securities and markets, but for long-acknowledged reasons. Their oversight was almost universally lax. Failed institutions avoided PCA restraints by artificially maintaining their well-capitalized status, sometimes with supervisory assistance, almost until they failed. Their supervisors had not employed their discretionary powers to discipline them. The article concludes by raising philosophical questions regarding supervisors' reluctance to use their discretionary authority and makes some practical suggestions for improving their performance.
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INTRODUCTION

In 1991, legislators enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA). They had seen academic concerns over principal-agent conflicts that were exacerbated by asymmetric information acted out in real life during the banking and thrift debacle of the 1980s and early 1990s.[1–4] Supervisors protected their own careers and, under regulatory capture, neglected their long-held discretionary powers to discipline miscreants and misdirected their efforts to serving the interests of the bankers they regulated, while jettisoning the needs of the general taxpaying public.[5–8] In response, two of FDICIA's major provisions – prompt corrective action (PCA) and least cost resolution – aimed to require regulators to serve the public interest.

PCA mandated that supervisors place a series of increasingly severe restrictions on the activities of a troubled bank or thrift if it did

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not correct its deficiencies and allowed its capital to continue to decline. Congress enacted additional discretionary powers to reinforce PCA's capital triggers for action. Legislators hoped that supervisors would correct weaknesses as soon as they perceived them in order to reverse an institution's path to destruction. On those – it was hoped rare – occasions when such correction failed, a nonviable institution was to be closed and resolved once its tangible equity capital fell to, or below, 2 per cent of its total assets.[9] Congress intended that closing an institution promptly before it became book-value insolvent would prevent serious losses to the Deposit Insurance Funds (DIFs). When PCA did fail to stem losses to the FDIC, the Act required the Inspector General (IG) of the federal banking agency, supervising the failed institution, to conduct a Material Loss Review (MLR). On the website, the FDIC's IG explains his MLR responsibilities as follows.

> Section 38(k) of the Federal Deposit Insurance Act states that when the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the inspector general of the appropriate Federal banking agency shall make a written report to that agency reviewing the agency's supervision of the institution (including the agency's implementation of prompt corrective action provisions of section 38), which shall ascertain why the institution's problems resulted in a material loss to the Deposit Insurance Fund; and make recommendations for preventing any such loss in the future. A loss is material if it exceeds the greater of US$25 million or 2 per cent of an institution's total assets at the time the FDIC was appointed receiver.[10]

At the time of its enactment, most commentators were optimistic that FDICIA would prevent a future recurrence of the $150 billion in losses that were incurred by the DIFs during the banking and thrift crises of the 1980s and early 1990s. 'Never again' became a Congressional slogan, but not everyone was so confident. Richard Carnell and Paul Horvitz warned in the 1990s that regulators would be unwilling to forgo their culture of *ad hoc* discretion.[11] George Kaufman and Robert Eisenbeis and Larry Wall noted in 2002 that the failures that were occasionally occurring during the late 1990s and early 2000s were proving to be unexpectedly expensive, suggesting that PCA was not working in the way that was intended.[12–14]

Failures became frequent again in 2008 and 2009 (Figure 1) and they were expensive (Table 1). These losses rendered the FDIC's DIF technically insolvent in 2009.[15] And it again, as in 1991, became dependent on its full faith and credit guarantee from the US Treasury, while it waited for increased and prepaid premiums from the banking industry to restore its financial integrity.

In 2010, the US Congress is again considering bills to reform the financial sector in an effort to discourage another financial crisis as vicious as the receding one. Although not the most important of the needed reforms, much discussion and dissent over the Treasury Department's financial reform proposal in 2009 and the House and the Senate bills concern the reallocation of supervisory powers for banks, thrifts and their holding companies.[16] In addition, in typical Washington fashion in the aftermath of a crisis, the reforms would create new oversight agencies. All three proposals, for example, provide for a new body to oversee systemic risk and another to protect the consumer from abusive bank practices. All three proposals would abolish the Office of Thrift Supervision (OTS). The Senate bill proposes to create a new supervisor that would take over the bank-by-bank supervisory responsibilities of the Federal Reserve (the Fed), the Office of the Comptroller of the Currency (OCC), the FDIC and the OTS.[17] In contrast, the House bill and Administration proposals would not consolidate these

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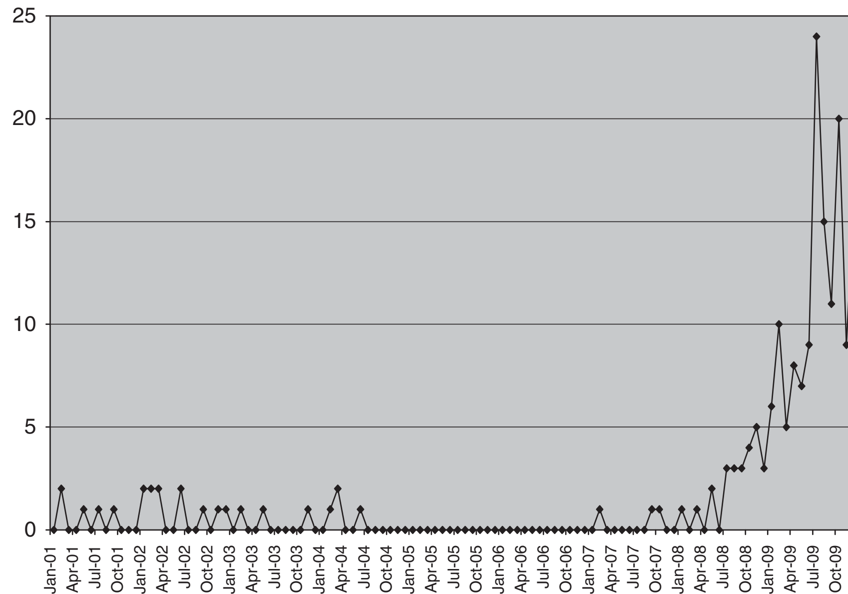

Figure 1: Number of bank and thrift failures by month: 2001–2009.
Source: Data from FDIC at www.fdic.gov.

supervisory responsibilities, which would remain as they were – except the OCC would take over OTS's responsibilities.[18] Agencies that are at risk of having the scope of their jurisdiction reduced are naturally resisting these proposals and are lobbying hard,[19] as is the banking industry.[20] Importantly, the reform proposals would impose additional regulations, but they ignore problems that exist in the implementation of existing regulations. That is, supervision – the topic of this article – is given short shrift in the proposals.

To throw some light on this controversy, this article examines performance by four federal financial supervisors (the FDIC, Fed, OCC and OTS) in their oversight responsibilities. To do so, it relies on the MLRs conducted by the IGs of the federal agencies responsible for supervising the institutions that failed in the calendar years 2007 through mid-2009 – the years in which failures of insured banks and thrifts escalated from the zero readings recorded for 2005 and 2006. In doing so, it recognizes that the IGs may not have complete command over the causes of the institutions' failures or the supervisory deficiencies that enabled them. Nevertheless, the MLRs are revealing. They show that supervision was deficient across the four agencies, so much so that it thwarted PCA.

The next section presents data on the number of failures for the years 2001 through 2009 and the material losses incurred by each supervisor in the reviews for 2007 onwards that they had been released by the end of 2009. The subsequent section examines the IGs' perspectives on the causes of bank and thrift failures and finds that the failed firms typically followed well-known paths to destruction. The fourth section summarizes the IGs' analysis of the federal supervision of the failed firm – it was found wanting. The last section generalizes and raises some important questions that lie beyond the scope of the article, but need to be answered before financial reform can be successfully accomplished. It concludes with some practical suggestions to improve supervisory performance.

Table 1: Failures and material losses: 2007–2009[a]

2009	*FDIC*	*FED*	*OCC*	*OTS*	*Total*
Total number of institutions[b]	5039	858	1505	773	8175
Their deposits[b] ($billion)	$1733	$962	$4142	$713	$7550
Number of failures[c]	77	16	29	20	142
Number of ML reviews[d]	21	3	6	2	32
Assets of ML insts. Reviewed[d] ($million)	$9785	$2390	$5616	$541	$18 322
Estimated losses reviewed[d] ($million)	$2910	$408	$1317	$168	$4803
2008					
Number of institutions[b]	5163	874	1515	809	8361
Their deposits[b] ($million)	$1642	$857	$3597	$923	$7019
Number of failures[c]	15	1	8	6	30
No. material losses and reviews[d]	11	1	1	4	17
Assets of MRL institutions[d] ($million)	$11 349	$229	$2,100	$48,600	$62 278
Estimated material losses[d] ($million)	$3354	$72	$214	$12,900	$16 540
2007					
Number of institutions[b]	5215	888	1676	815	8594
Their deposits[b] ($billion)	$1645	$831	$3274	$945	$6695
Number of failures[c]	2	0	0	1	3
No. material losses and reviews[d]	0	0	0	1	1
Assets of MRL institutions[d] ($billion)	0	0	0	$25	$25
Estimated material losses[d] ($million)	0	0	0	$108	$108
2007–2009[a]					
Number of failures: total	94	17	37	27	175
Number of MLRs	32	4	7	7	50
Assets of MLR institutions ($million)	$21 134	$2619	$7716	$74 141	$105 610
Estimated material losses ($million)	$6264	$480	$1531	$13 176	$21 451
Material losses as % assets	29.6	18.3	19.8	17.8	20.3

[a]Data through 31 December 2009.
[b]Numbers and deposits of institutions are taken from FDIC Summary of Deposit data for National Totals by Charter Class for June of each year. FDIC data include FDIC-supervised savings banks. OTS data include federally chartered and OTS-supervised savings associations at www.fdic.gov.
[c]Data are taken from the FDIC's Historical Statistics (2009) on Failures and Assistance Transactions, which include cases of assistance under a systemic risk determination at www.fdic.gov.
[d]Author's analysis of material loss reviews by the FDIC, the Federal Reserve, the OCC and the OTS published by end 2009.

BANK AND THRIFT FAILURES AND MATERIAL LOSSES

As required by law, the FDIC's Office of the Inspector General (OIG) issues its MRLs within 6 months after the loss becomes apparent and had released 11 for 2008 and 21 by the end of 2009 for the first half of 2009. As serious exercises in analysis that span between 30 and 60 pages, they are published prominently in a separate section of the OIG's website.[21]

The other agencies do not issue their MLRs so promptly. The Fed's IG had released only four reviews for 2008 through April 2009 on its website,[22] which states that another seven reviews were pending at the end of the third quarter.[23] Although the FDIC provides a wealth of information on the causes of failure and supervisory deficiencies in its MLRs, the Fed's four MLRs, in contrast, are more summary in nature. By the end of 2009, the Treasury Department's IG has published seven full MLRs for OCC-supervised banks that had failed in the period 2007 through March 2009 and seven for OTS-supervised thrifts through April 2009 on its website.[24]

Figure 1 shows the number of bank and thrift failures by month for the years 2001 through 2009. There were few failures early in the decade and none in any month in 2005 or 2006, but their numbers escalated thereafter to peak (through January 2010) at 24 in July 2009. Many more failures are expected to occur in 2010. Table 1 shows that 175 insured banks and thrifts have failed since 2006 and that material losses had reached $21.45 billion on the MLRs that had been published by the end of 2009 – 61 per cent attributable to the OTS.

Estimated material losses over the 3-year period show a loss rate of 29.6 per cent for the FDIC, 18.3 per cent for the Fed, 19.8 per cent for the OCC and 17.8 per cent for the OTS. The performances of the OCC and the OTS are worse than they appear in Table 1 because their mega institutions and regional banking powerhouses were not allowed to fail, but were merged under pressure and/or were rescued by the Troubled Asset Relief Program (TARP) and other sources of government assistance. Thus, their losses are not recorded. The Fed's record also looks stronger than it should because its IG had reported only four MLRs by the end of December 2009, and losses on the seven pending MLRs are estimated to be higher, bringing its overall loss rate on MLR banks to 28 per cent. This percentage is comparable to that of the FDIC, whose IG had completed 32 reviews. Therefore, the reader may conclude that the loss rate on the small and medium-sized institutions that were allowed to fail in 2007, 2008 and the first half of 2009 is only marginally below 30 per cent.

THE CAUSES OF BANK FAILURE

Tolstoy in his novel, *Anna Karenina*, writes 'Happy families are all alike; every unhappy family is unhappy in its own way'. This article questions whether, similarly, banks of different sizes with different supervisors fail for different reasons, or whether there are universal flags that signal failure for all banks, regardless of their size or supervisor. The President of the Federal Reserve Bank of Dallas, Richard Fisher reported that Paul Volcker sees universal themes among bank failures, commenting,[25]

> in his day he knew a bank was headed for trouble when it grew too fast, moved into a fancy new building, placed the chairman of the board as head of the art committee, and hired McKinsey & Co. to do an incentive compensation study for senior officers.

FDIC analysis

The supervisory agencies, from their extensive experience, have themselves analyzed the precipitators of failure. A pre-crisis FDIC OIG analysis, presented in Table 2, for example, sees four stages along a bank's path to failure as it focuses on deficiencies in the bank's corporate governance and in risk management (RM), and on concentration in its loan portfolio.[26] In stage one, there may be a change in business strategy that involves taking increased risk, often at the behest of a dominant individual; at the same time, the institution may switch its charter to a supervisor it deems to be more compliant. The change is also accompanied by weak RM, liberal underwriting and inadequate internal controls that facilitate fast growth.[27] The strategy may appear to be profitable in stage two, perhaps as a result of accounting maneuvers that exaggerate earnings and capital, but it is accompanied by concentrated lending, a disregard of concerns expressed by examiners and even by violations of laws and regulations. As the business appears to be profitable, the bank's board feels justified in continuing its policies and in ignoring the examiners' warnings.

In stage three, earnings peak and deterioration sets in. The reader might expect supervisors to be, already, taking enforcement actions – informal ones at least – by stage two or three, but enforcement actions are not

Table 2: Four stages of bank failure

Stage I: Strategy	*Stage II: Growth*	*Stage III: Deterioration*	*Stage IV Failing*
Corporate governance			
Changed philosophy	Violations of laws/regs.	More resistance to supervisors	Enforcement actions
Inattentive board	Insider abuse	Problems with accounts	Key officials depart
Dominant person	Disregard examiners concerns	Memoranda of Understanding or Board resolutions	
High-risk lending			
Lack of expertise			
Risk management			
No strategic plan	Poor diversification	Earnings peak, then decline	Severely deficient ALLL[a]
Weak risk management	Financially strong image	Inadequate loan loss reserves	Severely depleted capital
		Capital impaired	Need for capital infusion
Lending concentration			
Liberal underwriting	Rapid growth in niche	Significant loan concentration	Massive loan losses
Weak internal controls	High fee income	Growth plateaus	
Aggressive growth	Does not show losses	Loan problems exacerbated by recession	
	Poor credit administration		

[a]ALLL stands for allowance for loan and lease losses.
Source: FDIC, Office of the Inspector General (2004).

mentioned in the FDIC analysis until stage four, when the bank is already described as failing. Recession that has caused loan problems in stage three catapults the institution into failure in stage four. Only now are supervisors seen to be trying to close the barn door to errant actions by imposing enforcement actions, but the opportunity horse had bolted long ago.

IG insights

Most of FDIC's failure characteristics are listed in Table 3, which summarizes the IGs' assessment of the causes of failure.

A surprising number of the FDIC's failed banks belong to one-bank holding companies, perhaps because such small operations are undiversified and therefore are weaker. Eighteen of the MLRs are for banks that are less than 10 years old. Supervisors recognize that *de novo* and internet banks are prone to failure and therefore have given them special attention during their first 3 years. But the results in Table 3 suggest that a bank is likely to fail for much longer than its first 3 years. Moreover, the FDIC's newly instituted policy of extending additional attention for new banks to 7 years may not be a sufficient span for additional monitoring, because 10 of the failed banks were between 7 and 10 years old. They need to be monitored closely over a full business cycle. All of the IGs find that a change in business strategy, sometimes accompanied by a change in charter type and federal supervisor, was instrumental in 36 of the failures reviewed – a factor noted in stage one along the FDIC OIG's road to failure. Several states – most notably Georgia and California – had more than their fair share of MLR failures.

All IGs mentioned the onset of the financial crisis and ensuing recession as a factor contributing to the failures they reviewed. The Fed IG, however, emphasized the role of the

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Table 3: The causes of failure

Cause/Characteristic	*FDIC*	*Federal Reserve*	*Treasury*		
			OCC	*OTS*	*Total*
Number of material loss reviews for 2007–2009	32	4	7	7	50
Structure	—	—	—	—	—
New institution	18	0	1	1	20
Substantial change in the business plan and/or charter	21	3	6	6	36
Capital	—	—	—	—	—
Inadequate allowance for loan and lease losses	25	4	6	7	42
Assets	—	—	—	—	—
Fast growth	31	2	6	7	46
Concentrated asset portfolio – concentrated on:	31	4	3	7	45
(a) Risky types of home mortgages	7	1	3	3	14
(b) Acquisition, development and construction lending	28	4	1	2	35
(c) Commercial real estate loans	23	3	5	1	32
(d) Mortgage-backed securities	3	0	1	5	9
Management	—	—	—	—	—
Dominant individual(s)	13	0	5	3	21
Weak board and management	31	3	6	7	47
Inadequate risk controls	31	3	6	7	47
Weak underwriting and credit administration	32	3	6	7	48
Compensation system encourages risk	11	0	4	3	18
Ignored supervisory concerns	28	1	4	7	40
Violated laws and/or regulations	23	0	4	2	29
Earnings	—	—	—	—	—
Accounting violations	16	0	6	6	28
Misused interest reserves	16	0	3	2	21
Liquidity	—	—	—	—	—
Relied on volatile sources of funds, such as:	27	2	5	5	39
(a) Brokered deposits	24	4	5	4	37
(b) Federal Home Loan Bank advances	21	2	3	3	29

Source: Author's analysis of material loss reviews.

economy, listing it first among the causes of failure in three of its four MLRs and named it second for the remaining bank. The approach contrasts with that of the FDIC in Table 2, which implies that banks need to be strong enough to withstand recession.

Fast growth and concentrated portfolios are listed in stage two of the FDIC's failure analysis and they feature heavily among the causes of failure noted in the MLRs. For the majority of MLR banks, concentration was not on mortgage-backed securities (MBS) or the risky types of home mortgages that have been featured in the press. But the failed banks were indeed overexposed to the real estate markets – through lending for acquisition, development, construction (ADC) and commercial real estate (CRE) – in markets that had been inflated by others' use of these mortgage instruments.[28] Even where they did not themselves hold MBS, banks were adversely affected by the real estate bubble and its collapse, which was exacerbated by those that did purchase MBS.

As in the FDIC OIG analysis, the IGs perceived boards and senior management to be weak, frequently dominated by one person,

having inadequate control over risks, and conducting weak underwriting and credit administration. Supervisory concerns were often ignored and laws and regulations were violated. The IGs found risk-inducing systems of compensation to be a factor in 18 of the 50 failures reviewed. By appointing the special master for executive compensation (the pay tsar) for institutions receiving capital investments from the government, Congress expressed the belief that compensation policies that encourage undue risk taking contributed to the crisis. Bair (2010) also blames misaligned compensation practices for contributing to the financial crisis; therefore the FDIC is proposing to charge higher insurance premiums to banks that maintain compensation policies that it deems to be inappropriate.[29]

Market discipline can restrain risk taking by threatening weak institutions with default. FDICIA contains a provision to prevent weak institutions from dodging this discipline by funding themselves with high-rate brokered deposits, as they had done during the bank and thrift crises of the 1980s and early 1990s when troubled institutions offered high rates on insured deposits gathered by brokers to enable them to gamble for recovery.[30] Since FDICIA, only well-capitalized banks are permitted to court brokered deposits (unless the FDIC grants a waiver to adequately capitalized banks).

Although volatile sources of funding are not mentioned in the FDIC OIG's characterization of the stages of bank failure, funding did feature prominently in the MLRs. Auditors showed that 39 MLR banks were funding their assets, which were largely risky long-term assets, from volatile, non-core sources from the wholesale markets and/or through brokered and internet deposits and Federal Home Loan Bank (FHLB) advances. FDICIA's restriction on brokered deposit was often avoided, as will be discussed further in the next section, because, by making insufficient allowance for losses, banks and thrifts often retained their well-capitalized status almost until they failed. When supervisors forbore on requiring loss recognition, a new generation of failing banks was allowed to gamble for recovery at public expense.

When the failing institutions were finally denied access to brokered deposits, they were sometimes able to replace them with Federal Home Loan advances. Lender-of-last-resort provisions, such as Fed discount window lending, have long been made available to prevent *sound*, *viable* banks from failing for lack of liquidity. Banks became reluctant to use Fed loans during the 1990s, fearing that their borrowing would become public knowledge and that this would tarnish their reputation. Instead, banks came to rely more and more on FHLB advances, which had became available to banks that joined the system in the 1990s, as well as to savings institutions. Although advances initially were taken for longer terms than discount window loans, Adam Ashcraft, Morten Bech and Scott Frame have demonstrated that advances became a direct substitute for the discount window in 2007 and 2008.[31] Table 3 shows that auditors noted heavy reliance on FHLB advances at 29 of the MLR banks, which are typically secured by strong assets. Thus, the FHLBs, like the Fed in its secured discount window lending, have priority over the assets of a failed bank. Secured borrowing by the failed bank serves to reduce the pool of its assets on which the FDIC can draw to compensate claimants and therefore, if they replace uninsured funds, increases the losses the agency incurs. When access to both brokered deposits and FHLB advances was denied, weak banks became illiquid and failed.

With regard to earnings, the MLRs note that accounting malfeasance, such as that reducing the need to set aside reserves to cover losses and exaggerating earnings, were common. In particular, the abuse of interest reserves could make loans that would otherwise be classified as nonperforming appear to be current, thus reducing the need to provision against them.[32] By these and similar means, most (42) MLR banks maintained inadequate allowances for loan and lease losses (ALLL).

A notable feature of the MLR analysis is that the causes of failure that the IGs identified have been recognized for many years.[33] Although these reviews are done only of the banks that the authorities allowed to fail, almost all of the institutions analyzed did not fail because of exotic new derivatives and, except for the thrifts, did not invest heavily in the secondary mortgage market. Those activities were the province of the larger institutions, most of which were not allowed to fail, but were instead rescued with public funds and/or implicit and explicit guarantees. These observations lead the reader to ask what was wrong with the supervisory oversight of these 50 MLR institutions that made them unable to avert their failure by restoring them to health and to avert heavy losses to the DIF. The following section pursues these questions.

FAILED SUPERVISION

By the end of 2009, the IGs of the four federal banking agencies had conducted 50 MLRs for banks that failed during the period 2007 through mid-2009. These institutions failed with $105.6 billion in assets and $21.45 billion in estimated losses – a loss rate of 20.3 per cent – much higher than Congress intended when it enacted FDICIA.

IGs judged that supervision was slow and ineffective in all but two of the 50 reviews. Supervisors failed to follow up forcefully on examiner concerns and allowed weak institutions to ignore examiner warnings in 39 instances. They failed to enforce laws or regulations in 46 cases. The methodology sections of the MLRs revealed that the reviews relied heavily on examination work papers, which then led the auditors to question the examiners and senior supervisory personnel involved in the oversight of the failed institutions. The IGs complained of inadequate examination work papers in 35 of the reviews, but they typically did not comment on the extent to which inadequate work papers thwarted their investigations. It should not be difficult to improve work papers if management recommended it and provided additional training for examiners.

Funding: Brokered deposits and FHLB advances

The MLRs note that problem institutions were able to maintain their well-capitalized designations until the last minute and therefore could continue to operate without PCA restrictions, such as those regarding garnering brokered deposits. To deal with this problem, the FDIC RM manual urges examiners not to wait for the PCA restriction on brokered deposits to be triggered, but rather to question the safety and soundness of relying on volatile sources of funding, particularly by new institutions.[34] But the MLRs reveal that such remedies were not pursued. Even after *de novo* Main Street Bank revised its business plan in 2004, for example, FDIC examiners allowed the aggressive bank to draw 67 per cent of its funding from brokered deposits.

Although the FDIC says it does not discourage the use of FHLB advances in a well-managed funding program, its guidance cautions against abuse of the system, and particularly against replacing brokered deposits by advances when a bank's capital level has declined to prevent it from accessing the brokered-deposit market. This was the situation at Main Street Bank in 2008, which was able to obtain FHLB advances even though it was operating under an FDIC Cease and Desist order. FHLB advances represented 31 per cent of the estimated loss to the FDIC when MSB failed. FHLB advances are collateralized; as such they can increase failure costs to the FDIC when a bank fails because they subordinate the FDIC's position to that of the FHLB at resolution. Advances also subsidize risk taking because they relax the market discipline that fear of illiquidity imposes.

Supervisory guidelines

IGs noted that examiners in 46 of the MLRs ignored agency guidelines that had been

designed to help them identify and correct problem situations. They also reported that agency guidelines were insufficiently specific in a number of instances. For example, although the FDIC's 2000 Risk Manual states that there should be restrictions on FHLB advances to institutions without adequate capital, the MLR auditors for Main Street Bank could not find any guidance or regulations to implement this sensible precaution. In addition, although the FDIC issued guidance on concentrated CRE lending in December 2006, it prescribed extra scrutiny for CRE lending but placed no restrictions on it.[35]

The reader is left with the impression that examiners will not criticize an institution's actions unless these actions are explicitly mentioned in the guidelines and proscribed by regulations. That is, examiners feel unable to use their own judgment to say 'We judge this practice to be unwise'. When they did issue the warnings that their guidelines recommended, the MLRs show checklists of examiner warnings that were issued repeatedly over successive examinations to cite the same errors and/or violations. Vigorous action was not taken to force the errant institution to correct the errors or to cease violating laws and/or regulations.

Amending call reports

Adequate provisioning for loan losses is a *sine qua non* for adequately measuring an institution's capital and implementing PCA. Each of the regulators has statutory authority to impose civil money penalties in the event a depository institution files a false Call Report and the regulators have issued a joint policy statement on coordination with external auditors.[36] They also have power to require a restatement even of externally audited financial statements and can impose a cease and desist order if a bank fails to do so.[36] A recent SEC filing in 2010 demonstrates this process.[37] The Fed examiners began an inspection of Sterling Bank on 27 July 2009. At its conclusion, examiners orally warned the company and its independent auditors that, 'based on trends in asset quality, credit losses and other metrics, in comparison to various national and custom peer groups with comparable characteristics, the Bank's allowance loan losses should be increased by $5 million'. Despite discussions between the bank and its supervisors in the intervening period, this finding was confirmed on 30 November 2009 in a written examination report. The bank's board restated its 2009 data in January 2010 and notified the SEC.

Nevertheless, the MLRs show inadequate loan loss reserves in 42 of the 50 MLRs and accounting violations in 28 of them. This finding raises a question: why the examiners allowed this to happen? At what stage did they recognize reporting obfuscations – was it early enough for them to reduce measured capital and apply consequent mandatory PCA sanctions? The answer to this question is not clear from the MLRs.

Enforcement actions

Reading the reviews and knowing that the institutions later failed with significant losses, the reader wonders why supervisors did not act more forcefully or take stronger action earlier to effect remedies at the troubled institutions. There are several answers to this question. First, supervisors may be captured by those they regulate. Second, they may have difficulty in criticizing an institution when it is making hefty profits in a boom period. Third, bankers may push back and reject the criticism. Fourth, especially in good times, politicians may criticize the supervisors for their actions. Fifth, when times are bad, supervisors may forbear to give the institution a chance to regain its strength when the economy recovers. The OCC's MLRs, for example, considered that supervisors, in all but one case (Omni Bank), identified the weaknesses in each of the failed banks and reported them to the bank's board and management as matters requiring attention (MRAs). Although these warnings were largely ignored, OCC undertook *no* informal enforcement actions against the seven banks that later failed with material losses to the DIF. Not only

were there no informal enforcement actions against these failed banks, but formal actions were typically delayed until the bank was about to be closed. Although OTS did issue informal actions against five of its seven MLR banks, six of the 10 informal actions it took concerned one thrift (PFF Bank and Trust) (Table 4).

The FDIC's IG also noted that examiners typically identified the weaknesses that later led to failure but wrote that they were reluctant (or felt powerless) to act against institutions that were reporting strong earnings and were classified as well-capitalized. FDIC auditors, for example, summarizing their review of Silver Falls Bank, which was chartered in 2000 and failed in February 2009, noted that '[T]he FDIC has authority to take a wide range of supervisory actions.[38] Earlier supervisory actions may have been warranted to address Silver Fall's elevated risk profile before the problem became severe in 2008'. They explained the examiners' delay in taking urgent action as follows, 'because the bank was reporting high net income and capital along with a low level of adversely classified assets, examiners did not take additional supervisory actions to help address the bank's risks prior to 2008'. Similarly, characterizing as inadequate the supervisory oversight of Haven Bank and Trust, which was founded in 2000 and failed in December 2008, FDIC auditors reported that '[H]aven's apparently high level of earnings and apparently adequate capital levels along with an expectation by regulators that bank ownership would infuse capital when needed as they had done in the past, combined to delay effective supervisory actions'.[39]

Informal enforcement actions might have earned the attention of boards and management where warnings in examination reports did not. Examiners may also have been reluctant to use informal actions because it was agency policy to eschew them. The Treasury IG notes that it was OCC policy not to use informal enforcement actions, which the agency deemed to be ineffective. MRAs were the OCC's preferred supervisory tool.[40] OTS also expressed a preference for using Matters Requiring Board Attention rather than informal actions and similarly took formal action against PFF Bank and Trust only in the final days before closure. FDIC supervisors also postponed informal enforcement action and refrained from formal enforcement action until the bank was on the verge of failing. Recall that the FDIC's schematic for

Table 4: IG assessment of the supervision of MLR banks

	FDIC	*Federal Reserve*	*Treasury*		*National*
			OCC	*OTS*	*Total*
Number of MLRs	32	4	7	7	50
Assets of MLR institutions ($million)	$21 134	$2619[a]	$7716	$74 166	$105 600
Losses of MLR institutions ($million)	$6264	$480[a]	$1531	$13 139	$21 451
Loss rate	29.6%	18.3[a]	19.8%	17.7%	20.3%
Supervision slow and ineffective	31	4	6	7	48
Examiners failed to follow up	30	4	5	7	46
Supervisors allowed bank to ignore warnings	25	3	5	6	39
Examiners failed to follow supervisory guidance	32	3	5	6	46
Supervisors failed to enforce laws and/or regulations	23	1	6	5	35
Examiners left behind inadequate work papers	9	0	7	4	20
Informal enforcement actions	37	3	0	10	50
Formal enforcement action	37	7	10	11	65
Supervisors said to have conducted PCA appropriately	12[b]//9	3	6	4	12[b]/22

[a]Data for only MLRs completed. Losses for pending MLRs bring the Fed's loss rate to 28 per cent.
[b]Supervisors implemented the capital provisions of PCA correctly, but did not use their discretionary powers.

failure (Table 2) refers to enforcement actions only in stage four when the institution is already failing. When informal actions failed to remedy the troubled banks' problems, why did supervisors refrain from issuing formal enforcement actions almost until the institution failed? Such policies may need to be reassessed.

New banks

Researchers at the OCC and the FDIC have long recognized that new and internet banks fail at higher rates than established banks and that they invest in risky real estate assets.[41–43] They are therefore supposed to be given especial attention by examiners and careful off-site monitoring. One wonders why these researchers' cautionary findings were not forcefully conveyed to examiners, why the OIG's (FDIC, 2004) analysis had scant effect and why the OIG and agency researchers had apparently had such little impact on supervisory practices.[44] Extending *de novo* oversight from 3 to 7 years, as the FDIC did in 2009, may not be enough to contain the risks that new institutions pose. As noted above, a number of 10-year old banks have failed with material losses.

Peer group analysis

The MLR audits adopt the agencies' common practice of comparing failed banks' operations and policies to those of their peers to show that the failed banks held riskier asset and liability portfolios than their peers. Yet, analysis by comparing a bank with its peer group can weaken the case for remedial action. Peer group analysis can lead supervisors to overlook systemic problems as they develop. In boom times, it is a systemic problem when many banks grow fast, use volatile sources of funding and invest in risky real estate assets. Instead of relying on peer group analysis, supervisors might want, instead, to conclude that the banking system is not being supervised adequately when only those institutions that exceed peer group averages are criticized for their behavior. Greater emphasis on systemic, rather than individual-bank, problems might make the deficiencies of peer group analysis apparent and lead supervisors to relinquish, or at least downplay, it.

Prompt corrective action

The reader of these 50 MLRs may readily conclude that the PCA provisions of the 1991 FDIC Improvement Act did not achieve the results that Congress intended for any of these failed banks. Yet the IGs stated that they considered that the legislation's PCA provisions (FDI Act Sections 38 and 39) were implemented correctly in 22 cases. Thus, the IGs, in many of the reviews, considered only the capital triggers in PCA and ignored the supervisors' failure to use their discretionary powers. In only three of the reviews – those for Main Street Bank (FDIC), County Bank (the Fed) and IndyMac (OTS) – did the IGs state that the PCA provisions were not correctly implemented. The FDIC IG noted that the capital provisions were implemented correctly in an additional 12 of the failed banks, but that their supervisors did not use the discretionary powers contained in Sections 38 and 39, which are discussed further below. In the remaining 13 MLRs, the IGs described the actions that supervisors took without commenting on their appropriateness from the perspective of PCA.

The audit reports typically explained that PCA actions were triggered when banks breached capital thresholds and that capital is a lagging indicator. But this fact has been known for a long time. The FDIC's OIG had warned, earlier in 2003, 'that PCA's focus is on capital, and because capital can be a lagging indicator of an institution's financial health, a banks' capital can remain in the "well to adequate" range long after its operations have begun to deteriorate from problems with management, asset quality, or internal controls'. Registered capital did fall precipitately, for example, at Magnet Bank, which was chartered in 2005 and failed in 2009. Its status fell from well-capitalized to critically under-capitalized

in the few months between late 2007 and September 2008.

Repeatedly the MLRs show that institutions reported artificially high capital levels almost until they failed. They did this by using, for example, interest reserves to make under-performing loans, that needed allowances, appear to be current, thus exaggerating earnings and overestimating capital. Failed banks also made inaccurate call reports and ignored supervisory warnings on their quality and delayed submitting amended reports. The audit of Magnet Bank reported that it delayed reporting its decreases in capital, thus thwarting supervisory action and prolonging its access to brokered deposits, which it needed to maintain its liquidity.[45] In the case of American Sterling Bank, the MLR noted 'the thrift's inaccurate financial reporting delayed OTS from taking required PCA as the thrift's capital was depleted'.[46]

Backdating capital injections

PCA was thwarted across the supervisory board, but this exercise was particularly egregious at OTS, where senior officers permitted, even required, capital contributions (for example, from the holding company) to be backdated to allow the deteriorating thrift to be falsely maintain its well-capitalized status. A special report by the FDIC's OIG examined instances of backdating capital infusions and explained their significance for IndyMac as follows:[47]

> The impact of OTS's approval to record the capital contribution in the quarter ending March 31, 2008, was that IndyMac was able to maintain its 'well-capitalized' status, and avoid the requirement in law to obtain a waiver from FDIC to accept brokered deposits. It also solved another problem in that the independent auditor had advised IndyMac management that without IndyMac's acceptance of several proposed adjustments relating to the thrift's capitalization, the independent auditor would not have signed-off on the interim review. IndyMac needed the signed interim review in order to file a complete quarterly report (10Q), as required, with the Securities and Exchange Commission on May 15, 2008.

This report also explained (p. 19) the significance of backdating for another of five thrifts that were not named because they were still operating but had been found to have backdated capital contributions.

> The CFO also stated that the potential ramifications of filing the June 30 TFR as adequately capitalized, combined with the significant losses and elevated volume of classified assets, could create a liquidity crisis and materially impact the thrift's future viability. The CFO told the examiners that it was imperative that the thrift's well-capitalized status be maintained in order to have access to the broker deposit market for liquidity purposes.

Ignoring PCA's discretionary provisions

Regulators in the United States have long been granted broad discretion to discipline errant institutions. PCA reiterated this authority in Sections 38 and 39 of the FDI Act, and again gave supervisors wide authority to use their discretion to reign in undue risk taking. Section 38 (g), for example, allows the Federal banking agency to downgrade the capital designation by one grade if 'it determines (after notice and an opportunity for hearing) that an insured depository institution is in an unsafe or unsound condition or … deems the institution to be engaging in an unsafe or unsound practice'. Downgrading an institution from well- to adequately capitalized would have denied a deteriorating institution the ability to garner brokered deposits without an FDIC waiver. Sections 38's discretionary powers also

allow agencies to take further action. For further example, Section 38(f)(2)(F) allows regulatory agencies to require an undercapitalized institution to improve management when they consider it to be deficient.[48]

Section 39 empowers regulators to take action against virtually all of the failure-causing problems that the MLRs have revealed. It allows regulators to require the submission of, and speedy compliance with, a remedial plan from institutions, which they identify as having problems that encompass: (1) operations and management[49]; (2) asset quality, earnings and stock valuation; and (3) compensation. The FDIC's Risk Management (RM) Manual and Formal and Informal Action Procedures (FIAP) Manual have procedures that address Section 39 provisions. For example, the FIAP manual states that a Section 39 action can be initiated for non-problem institutions 'in which inadequate practices and policies that could result in a material loss to the institution or management has not responded effectively to prior criticism'.[50] Despite PCA's discretionary authority, the MLR for FDIC-supervised Westsound Bank claimed in the Executive Summary (p. 3), 'PCA did not require action until the institution was at serious risk of failure'.[51]

But the MLRs do not report that discretionary actions were taken, although FDIC auditors thought them appropriate in 12 of FDIC-supervised cases. The other three IGs did not refer to PCA's discretionary powers. Was this agency policy? Did supervisors regard Section 38 as eviscerated by giving the errant institution an opportunity for a hearing? One wonders if reform proposals to give authorities additional regulatory powers will be effective when existing powers are not used to take enforcement action against unduly risky institutions until they are on the brink of failure.

The OCC and the OTS reject their IG's criticism

In response to most, but not all, audits, senior management of the supervisory agency agreed with the findings and offered to make changes to respond to the criticism. The FDIC IG states that it will conduct an overall assessment of its individual MLRs, draw conclusions from them and make recommendations for supervisory improvements. The OCC, however, rejected criticism by the Treasury IG on its handling of Omni Bank. The MLR noted that the OCC's examiner for several years missed 'excessive growth, a risky product and clientele, geographic expansion', which had long been recognized by the agency as red flags.[52] Neither did the examiner-in-chief note that the bank was replacing foreclosed loans with larger loans to hide the losses. Nevertheless, OCC management disagreed with the IG that more timely enforcement action had been needed for Omni Bank, which had relied on appreciation for repayment of its loans and had submitted inaccurate call reports.[53] The agency judged that its PCA actions were correct based on the false call reports. Once the reports were recognized as deficient, corrective action was delayed, however, for 6 months by a disagreement with the external auditor. Formal enforcement action was further postponed until October 2008 to allow the agency to marshal legal support for its actions, even though a new examiner had recommended it in February. The IG criticized the agency for delaying formal action against Omni Bank, but OCC management rejected the criticism and maintained that it needed the time it took to justify and document the need for formal action. The IG in turn disagreed with the OCC and considered that the PCA was delayed by 6 months as a result. It is perhaps ominous for the hopes of supervisory improvement that the Comptroller of the Currency, responding to the MLR, rejected the IG's criticism of the agency's delay in taking enforcement action.[54]

> Again, I agree that it is absolutely critical that enforcement actions are timely. I do not agree, however, that the facts of this case support a conclusion that the OCC process used to issue the consent order, in

response to the 2008 examination findings, was slow and requires review.

OTS has also rejected IG criticism. The MLR for IndyMac criticized OTS's handling of the failed bank and stated that it should have taken PCA earlier. It noted 'OTS's West Region officials and examiners believed their supervision was adequate. We disagree'.[55]

CONCLUSIONS

It would be better if the United States made some major decisions on issues mentioned in this section, but which lie beyond the scope of this article. In the meantime, as the Congressional Financial Crisis Inquiry Commission (FCIC) investigates the causes of the crisis and Congress debates financial reform, it may be necessary to follow up on this article's conclusions. These can be divided into three parts: (1) the causes of costly bank failures; (2) problems with the oversight of the failed banks and (3) practical recommendations for supervisory improvement.

The causes of costly failures

With respect to the 'Tolstoy question' on similarity in the causes of failure, the MLRs show that the reviewed banks failed for the same reasons: weak management; excessive risk taking; overconcentration in real estate assets; deceptive accounting and reporting; and funding long-term assets from volatile, short-term sources. These are deficiencies that have long been recognized as indicators of financial destruction. The only unprecedented contributor mentioned is new forms of poorly underwritten mortgages to the subprime and alt-A markets. Otherwise, the IGs of Treasury, FDIC and Fed all show, in their reviews of the banks and thrifts that were put into receivership, that they failed for reasons long acknowledged as predictors of failure.

New sources of risk-taking in the secondary and derivative markets have devastated the mega banks and thrifts. Only IndyMac and Washington Mutual among the very large insured institutions and Lehman Brothers among non-insured mega firms were placed into receivership.[56] The rest, financial and industrial, were rescued by the TARP and other government guarantees or were merged under duress and then rescued. As such, they are not the subject of IG inquiry, but they should be. Their story needs to be told by independent and knowledgeable investigators to calm public anger and to allow Congress to take appropriate action to discourage a recurrence.

Failed supervision and PCA

Perhaps the regulators did not perceive – or when they were warned, willfully did not, or felt they could not, act on the advice – that the US banking sector as a whole was over exposed to the real estate markets.[57] Supervision focused on the health of individual institutions. Analysis by peer comparison – universally practiced by the supervisory agencies and their IGs – was symptomatic of this focus and it contributed to missing the macro red flags. If everyone was doing something – ADC or CRE lending or funding by brokered deposits or FHLB advances – supervisors judged it to be acceptable. Only if an institution stood out as undertaking noticeably more (or less) of it was it seen as a cause for concern. Supervision by peer comparison needs to be rethought if supervision is, in future, to consider the banking sector as a whole in addition to overseeing individual institutions.

The loss reviews by all of the IGs repeat the same theme – supervision was slow and ineffective. Examiners typically identified the problems that would later lead to failure but were unwilling or unable to resolve them. There are several possible reasons for these lacunae. One answer looks at the situation from the supervisors' perspective – their motivation. The supervisors needed to take action when times were good, when banks were highly profitable, but when bankers were taking too

many risks. But some supervisors had become complacent during the long period of the 'Great Moderation'. During such a period, bankers were likely to push back, reject examiners' criticism, legally challenge supervisory discipline and complain to the political class about overregulation. In response, some politicians would support the complaining bankers and intervene on their behalf directly with the regulators or through the press. Faced with such outcomes, supervisors may have caved in, convinced themselves that 'this time it is different', and refrained from taking disciplinary action until it was far too late.

Alternatively, the weak enforcement of existing laws and regulations, such as omitting to use discretionary PCA powers, might have been the result of individual supervisors being captured by the industry, that is, 'micro regulatory capture'. Or it might have reflected administration/agency policy in favor of light-touch supervision – a situation in which the legislative and administrative branches of government as a whole have been suborned – a situation that might be described as 'macro or systemic regulatory capture'.[58]

Michael Pomereano and Andrew Sheng, responding to Her Majesty's two famous questions,[59] have observed that there has been a major failure of public sector governance. In this failure, the financial revolution has been intellectually or otherwise captured by the financial community; compartmentalization has led to no one seeing the big picture; regulatory arbitrage has allowed risky institutions to escape discipline; disaster myopia has permitted regulatory agencies to believe that this time is indeed different; career-management concerns have encouraged potential Cassandras, recognizing that they rarely succeed, to remain silent; accountability avoidance, working on the principle that it is better to be conventionally wrong than unconventionally right, has led supervisors to accept overtly optimistic valuations and forbear; and, finally, pressures from international competitors in the global financial market place have imposed a requirement for an international consensus before regulations can be reformed or enforcement improved.

Throwing light on the major issues discussed just above lies beyond the remit of this article. It can contribute, however, to understanding to what extent supervisory failure can be attributable to objective, non-political, simply remediable obstacles to the effective enforcement of healthy behavior. PCA was designed to overcome both micro- and macro-regulatory capture, but clearly did not, at least in these MLR instances. It would be informative if Congress' FCIC could find counter examples where PCA did work, where its discretionary authority was used to promptly rein in errant behavior. In addition, it could investigate effective means to hold regulators (as well as the boards and management of failed firms) accountable – even after they have left office – for their actions. Is the naming and shaming of involved individuals enough to deter micro capture or should monetary penalties and even criminal prosecution be considered? Should the United States adopt the Canadian approach to strengthening its banking system by setting sound business and financial practices and monitoring banks' adherence to them? Enforcement might be a fruitful area in which to apply the analysis of Steven Shavell toward designing effective deterrents and punishments.[60]

The regulatory structure in the United States with its plethora of agencies is recognized to be problematic. Some argue that agencies perform better if they have one, clearly defined, mission, and that supervision should be transferred to the OCC from the FDIC (whose primary mission is deposit insurance), from the Fed (whose main focus is on monetary policy), and from OTS (which has shown a particular inability to extricate itself from regulatory capture). Others note that the OCC, a part of the Treasury Department, may find it difficult to remain immune from political pressures. The data provided by the three IGs do not offer support that any particular agency performed

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better in its supervisory responsibilities than the others. If the FCIC is to make a recommendation on regulatory structure, it should investigate regulatory (particularly PCA-induced) successes as well as failures.

The FCIC might also try to determine the extent to which reluctance to implement existing regulations derives from philosophical beliefs that the efficient operation of unfettered free markets will achieve the best outcome for the public with a consequent aversion to regulation. Alternatively, to what extent does the reluctance reflect a surplus of regulations that have become too excessive to enforce and possibly redundant? Is it time for a zero-based reconsideration of necessity of the current mass of federal financial regulations? Or is supervisory failure reflective of a political system that has been overtaken by the interests of the financial classes? Campaign finance reform has not succeeded in redressing the balance to date. But an angry public wants to know the reasons – and what to do in response to them. In the meantime, enacting more laws and regulations that will not be studiously implemented will not avert future crises. Congress may want to find answers to these questions before it enacts further regulations that supervisors will be unable or unwilling to enforce.

Immediate, practical recommendations

Although the country searches for answers to these fundamental questions that lie beyond the scope of this article, the analysis conducted so far can suggest a number of marginal, practical improvements. Changes that can be readily undertaken include: following the fortunes of new banks carefully over a full business cycle; requiring regulators (and their IGs) to pay more attention to systemic problems and to downplaying peer group analysis; activating the discretionary components of PCA; improving examiner work papers; finding ways to make informal enforcement actions effective and using the threat of, and actually implemented, publicly released early formal enforcement actions to discipline errant institutions. Regulators need to be persuaded that the threat of publicly available adverse information can be designed to act as a deterrent to undue risk taking by weak institutions and not as an inducement for their customers to run and regulators to forbear.

These changes could improve supervisory performance to resolve the problems of individual institutions, but leave issues relating to systemic regulation unaddressed. Peer group analysis can be seen as an example of the fallacy of supervisory composition and should be downplayed. The FCIC could consider Larry Wall's proposal in 1997 – to simultaneously increase market discipline and provide information on the extent of systemic risk – to have the FDIC issue contingent capital notes.[61] Further, the MLRs do not examine the systemic repercussions of supervisors' responses to errant institutions. As the nation shifts focus towards systemic supervision, it is time to ask the IGs also to consider these issues in their reviews of materially costly failed banks. They need to consider the dynamic aspects of supervisory behavior and its effects on the economy. The MLRs issued early in 2010, when this article was completed, show no sign yet of such an evolution.

The future

Congress should not expect that adopting these practical recommendations will solve all of the problems facing the United States. It may be wise for the country to make some other fundamental decisions that lie well beyond the scope of this article. A number of decisions need to be made about the future direction of the economy and the financial system before embarking on lasting regulatory reform. These issues include deciding to what extent public policy should continue to favor the housing industry; and whether it is not time, instead, to switch US policy away from subsidizing non-tradable goods in favor of tradable goods that can reduce US imbalances. These questions need to be answered before

lasting decisions can be made on changing the roles and status of the housing GSEs and for the FHLB – decisions that will impact health of the banking and thrift industries.

It is essential to identify ways to improve supervisory accountability as Kane has long argued.[7,8] Answers will be important not just in the United States, but also in other countries that rely on supervisory discretion. The United Kingdom, for example, as Maria Nieto and Gillian Garcia point out, has recently given the Bank of England, the Financial Services Authority and/or the Home Secretary the highly discretionary powers to apply to the court for a bank insolvency order and to take other steps to avert a systemic crisis.[62] As there is not one agency that is responsible, it will be difficult to apportion blame. Will naming and shaming be enough to provide accountability? In the United States, as a step toward naming and shaming, the MLRs already criticize the actions of both individual examiners – identified by their titles but not their names – and also the agency's top management. Some regulators, even senior managers, have departed from their posts after being criticized. But the threat of such action has not thwarted forbearance; therefore this remedy appears not to be sufficient. Perhaps financial penalties (inverse bonuses) may need to be imposed, even after the incumbent has left office.

Finding answers to all of these questions – philosophical and practical – is important and not just for the United States. The European Union (EU) and some non-EU countries have been attracted to the concept of PCA and is considering adopting it as Gillian Garcia, Rosa Lastra, David Mayes, Maria Nieto and Larry Wall, have pointed out.[63–65] Before they do so, they need to draw lessons from the failure of PCA in the United States, and should design their own PCA schemes appropriately. The article has observed in the MLRs that supervisors in the United States have not used the discretion they have been granted in FDICIA, as an adjunct to PCA's mandatory requirements, and elsewhere. Those countries that have already adopted PCA may need to adjust their requirements to shift even more toward mandatory action, while placing even less trust in supervisory discretion. Importantly, supervisors' incentives need to be changed, both in the EU and the United States so that they better reflect the public interest.

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46 See, United States Department of the Treasury, Office of the Inspector General. (2009) Safety and soundness; Material loss review of American sterling bank. OIG-09-011, 9 December. www.ustreas.gov/inspector-general/audit-reports/2010/OIG10011%20(American%20Sterling %20MLR).pdf, accessed 21 December 2009.
47 See United States Department of the Treasury, Office of the Inspector General. (2009) Audit report: Safety and soundness: OTS involvement with backdated capital contributions by thrifts. OIG-09-037, 21 May.
48 The IG report for Main Street Bank (p. 23) states 'Section 38(f)92)(F) for regulatory agencies require an institution to improve management when regulators consider management to be deficient'.
49 Operational and managerial standards include: internal controls; information systems; internal audit systems; loan documentation; credit underwriting; interest-rate exposure; asset growth; compensation; fees; and benefits; and other operational and managerial standards that the agency determines to be appropriate.
50 The FDIC's RM manual is cited above in Ref. 33. the FIAP manual is available at www,fdic.gov.
51 See FDIC, Office of the Inspector General. (2009) Material Loss Review for Westsound Bank. Report No., MLR-10-005, December.
52 See page 23 of the MLR for Omni Bank (See Ref. 39).
53 The bank's failure imposed not only a $288 million loss to the DIF but also a $1 million loss to the FDIC's Transaction Account Guarantee Program.
54 See page 59 of the MLR for Omni Bank (Ref. 39).
55 See United States Department of the Treasury, Office of the Inspector General. (2009) Safety and soundness: Material loss review of IndyMac bank, FSB. OIG-09-032. www.ustreas.gov/inspector-general/audit-reports/2009/oig09032.pdf, accessed 21 December 2009.
56 JPMorgan Chase took over Washington Mutual's assets and deposit without cost to the FDIC. Perhaps CIT Group (earlier called the Commercial Investment Trust) could be added to this list as a fourth mega failure.
57 Edward Gramlich, for example, gave such warnings. See Gramlich, E. (2007) *Subprime Mortgages: America's Latest Boom and Bust*. Washington DC: The Urban Institute.
58 James Coffman sees capture as a macro/political problem, explaining 'Much of the problem arose from decades of deregulation dating back to the beginning of the Reagan administration. Elected deregulators appointed their own kind to head regulatory agencies and they, in turn, removed career regulators from management positions and replaced them with appointees who had worked in or represented the regulated industries. These new managers and, in many cases, the people they recruited and promoted, advanced or adhered to a regulatory scheme that, at least with respect to the most important issues, advanced the interests of the regulated'. See Coffman, J. (2009) An inside perspective on regulatory capture. The Baseline Scenarion, August 14. http://baselinescenario.com/2009/08/14/an-inside-perspective-on-regulatory-capture/, accessed 14 January 2010.
59 The Queen asked in November 2008 at the London School of Economics, 'Why had nobody noticed that the credit crunch was on its way? Why didn't the public sector authorities, entrusted as guardians of financial sector stability and our savings, see the crisis coming and respond quickly to diffuse, or at least mitigate, the damage?' See Pomerleano, M. and Sheng, A. (2010) A failure of public financial sector governance. in 'The Financial Economists' Forum'. http://blogs.ft.com/economistsforum/2010/01/a-failure-of-public-financial-sector-governance/, accessed 26 January 2010.
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62 See Nieto, M. and Garcia, G. (2009) Saneamiento y Liquidation de Bancos con Actividad Transfrontiera en Europa. In: *Papales de Econommia Española: Crisis y Regulación Financiera* (122): 166–179.
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