
FRBSF WEEKLY LETTER

December 7, 1990

How to Close Troubled Banks

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) commissioned a joint task force of government agencies to prepare recommendations for reforming the deposit insurance system. Banking industry observers eagerly await the results of this study, scheduled for release early next year. Major reforms are needed to prevent a recurrence of the problems recently suffered by the thrift industry.

Deposit insurance reform is not, however, the only element of bank regulation that demands attention. Another is the process of closing troubled banks. It is simple to suggest that bank supervisors treat an insolvent bank like any other bankrupt firm, and close it immediately upon insolvency. In reality, supervisory practice and industry accounting standards have prevented timely closure.

In this *Letter*, I describe current procedures for resolving problems at troubled banks, and suggest that a tightening of procedures can go a long way toward promptly closing insolvent banks.

Supervisory practice

The current procedure for resolving bank insolvencies relies to a great extent on the discretion of bank supervisors at the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve System, and state banking commissions. Perhaps the best way to describe this process is one of progressive discipline and orderly resolution.

A crucial component of the process is the regularly scheduled bank examination. The supervising agency examines banks, and the examiners pass judgment on both general and specific aspects of a bank's condition. The primary evaluation criterion is the bank's composite CAMEL rating, a confidential figure currently disclosed only to bank management. Examiners derive this rating from assessments of the Capital adequacy of the bank, its Asset quality, the strength of its Management, its Earnings, and its Liquidity.

Supervisors consider banks with composite CAMEL ratings of 1 or 2 to be in good condition, and generally allow them to operate without restriction. A rating of 3 indicates that a bank is weaker than desired and deficient in some areas covered by the rating process. CAMEL ratings of 4 or 5 indicate that a bank suffers significant problems and may be a candidate for insolvency.

Although the CAMEL rating includes an assessment of bank capital, there is some interplay between required capital ratios and the composite CAMEL rating. Capital represents the funds invested in the bank by its owners. These funds act as a buffer to shield the bank from losses in asset values. Capital ratios are these invested funds relative to the total assets of the bank.

All banks must satisfy a system of minimum capital requirements, which includes the international risk-based capital standards. Above these minimum levels, however, regulators may exercise some discretion regarding how much capital a bank should hold. Regulators may thus permit banks with strong composite CAMEL ratings to hold less capital than banks with lower CAMEL ratings.

In addition to the CAMEL rating, bank examiners consider the quality of a bank's loan portfolio by examining individual loans. During this process, they may categorize loans as "substandard" or "doubtful" depending on the expected ability of borrowers to make scheduled interest payments and repay principal. For loans in these categories, bank examiners may require management to add to loan loss reserves and thus provide for potential future loan losses. Bankers generally take these loan loss provisions from the current net income of the bank or, if income were not sufficient, directly from bank capital.

Examiners may require a bank to "charge off" loans that are particularly bad and face little chance of repayment. That is, they require the bank to recognize the losses. The bank would

FRBSF

charge the losses against its loan loss reserves, or against capital if reserves were insufficient.

Progressive discipline

A bank whose CAMEL rating declines or whose capital position deteriorates is increasingly likely to face restrictions on its activities. In general, the restrictions become more severe the worse off the bank. The supervising agent chooses the appropriate restrictions on a case-by-case basis.

One example of an early restriction is a demand to report more frequently on the condition of the bank. Supervisors may reduce the interval between examinations, and may require bank management to provide specific information relevant to the perceived problem areas. These requirements improve the flow of information about the troubled bank, and may enable supervisors to intervene quickly should problems worsen.

Supervisors will give a "capital call" to a bank they consider to have insufficient capital. The bank must then submit a plan describing how it will raise new funds to meet capital standards. Supervisors prescribe an amount of time for the bank to raise needed funds and, thus, to satisfy capital requirements.

If a bank were unable to raise additional capital, or if its condition were to deteriorate further, supervisors could impose increasingly severe limitations on its management's latitude. These limitations appear in documents such as "memoranda of understanding," "written agreements," and "cease and desist orders." Among other things, these directives may restrict the amount of dividends the bank can pay, reduce its freedom to attract new insured liabilities, or induce it to tighten loan standards. The intent of these restrictions is to curtail the risk-taking behavior of the bank, and thus to protect the deposit insurance fund from further potential losses.

Orderly resolution

As the capital, and therefore the net worth, of a bank approaches zero, supervisors may determine that the bank is no longer "viable." They may then subject the bank to more direct intervention. In the typical procedure, supervisors appoint a conservator (usually the FDIC) to replace the bank's management and assume the daily operations of the bank. Supervisors can

officially declare a bank with zero net worth to be bankrupt, and appoint a receiver (again, usually the FDIC) to dispose of it.

Since the imposition of conservatorship or receivership is an extreme step, supervisors must presume that the bank is too far gone to have any reasonable prospect for recovery. The goal of the conservator or receiver, therefore, is to provide an orderly "resolution" of the bank. A frequently used resolution procedure is a "purchase and assumption" (P&A) transaction, in which a solvent bank purchases the loans and other assets of the failing bank and assumes its deposit liabilities. The FDIC must provide inducements to attract purchasers in cases where failed banks have negative market-value net worth. The majority of the FDIC's transactions during the past several years have been such "assisted" transactions. Other types of assisted transactions include "bridge banks" and "modified payoffs."

Alternatively, bank supervisors may decide that a P&A transaction is not feasible and may instead choose to liquidate the bank. That is, they dissolve the bank and sell its assets with the intention of recovering as much of the original asset value as possible. The supervisors use the funds from this sale to pay off insured depositors. In general, the deposit insurer would make up any shortfall of assets relative to insured liabilities.

Problems with current practice

Supervisors intend the techniques described above to minimize the disruptive effects of a bank insolvency and, at the same time, minimize the costs to the deposit insurer from the closure. To limit the exposure of the insurer, supervisors should base progressive intervention and orderly resolution on a bank's market-value net worth. In this way, the deposit insurer can minimize the losses inherent in assisted transactions or liquidations.

In practice, the intervention process has deviated from this ideal in a number of ways. First, there are lags in recognizing and identifying problem loans. Economic conditions may change abruptly, leading to rapid deterioration in the credit quality of a bank's loan portfolio. Since bank exams normally take place at most only once a year, problems can develop before bank supervisors have a chance to tag them for supervisory action.

Second, regulations set bank capital requirements on a book-value basis, not on a current or market-value basis. However, book-value

capital ratios may not accurately reflect the current, potential burden imposed on the deposit insurer by troubled banks. Such inaccuracies may permit institutions to continue operating despite market-value insolvency. Although problems may exist in implementing market-value accounting for banks, a sole reliance on book-value capital standards may not adequately shield the insurance fund from loss.

Finally, a discretionary intervention process leaves open the possibility that supervisory incentives will mitigate *against* closing troubled institutions. For example, economist Edward Kane has suggested that perverse regulatory incentives contributed to the thrift crisis because closing already insolvent S&Ls would only highlight the regulators' failure to act earlier. To Kane, and others, regulatory discretion means regulatory forbearance.

Some observers counter this argument by suggesting that concerns about systemic risk in the financial markets requires supervisory flexibility in responding to troubled institutions. Moreover, they claim that bank supervisory and regulatory practices are based on the presumption that supervisors will not forbear. Despite these arguments, a supervisory policy based on discretion opens the door to possible forbearance.

Evolution, not revolution

Because current procedures for intervening in and resolving troubled banks have not successfully sheltered the deposit insurance fund from losses, some critics have suggested a complete overhaul of the banking system. Less extreme measures, however, may achieve the same result.

First, supervisors could initiate progressive disciplinary procedures at higher capital levels. Such intervention would reduce the adverse effects on the insurance fund of lags in recognizing and identifying the problems in bank portfolios. More capital would then exist to buffer the fund against losses. In addition, higher capital requirements would reduce the incentive for banks to take extra risk in the first place.

Second, although it may not be practical for banks to increase the frequency of reporting,

they can improve the content of data provided. The goal here is to provide the information necessary to identify problematic assets *before* they become actual problems. In this context, supervisors could require banks to make market-value adjustments to the book values of their assets and liabilities, including adjustments for losses resulting from changes in interest rates. For example, long-term, fixed-rate assets (such as fixed-rate mortgages or long-term bonds) suffer losses in value when market interest rates rise. These interest rate increases reduce the market value of the bank. Data reported to supervisors should reflect the reduction. In this way, it may be possible to identify those banks most likely to be affected by a regional economic downturn or real estate slump.

In addition to identifying the market values of assets and liabilities, supervisors could require true market-value capital standards. Market-value capital ratios provide a better measure of the net worth of banks. Moreover, a bank would be less able to disguise its true net worth from supervisors when market-value capital ratios trigger intervention and resolution procedures.

Finally, while bank supervisors do not willingly keep insolvent banks open, reform efforts should probably include curtailing the scope of regulatory discretion to prevent any moves toward forbearance. Reform could provide for an automatic triggering of progressive intervention by, for example, a drop in capital or a declining CAMEL rating. Similarly, new regulations could allow supervisors to place any bank that fell below some minimum market-value capital ratio (preferable greater than zero) into immediate conservatorship. Reform efforts also should probably limit regulatory discretion to making standards tighter rather than looser.

The changes outlined above are not as radical as some other proposals for reforming the banking system. As suggested, incremental changes to the current supervisory structure and practices may be quite effective in preserving the integrity of the deposit insurance fund.

Jonathan A. Neuberger
Economist

Research Department
Federal Reserve
Bank of
San Francisco

P.O. Box 7702

San Francisco, CA 94120