

Panel 1

Examination and Enforcement

Comment on Examination and Enforcement **R. Alton Gilbert***

I commend the staff of the FDIC for preparing the papers in this volume on the problems of banking in the 1980s. These papers present information not available from other sources. The paper on examination and enforcement (FDIC, 1997a), in particular, presents information on the record of examinations of troubled banks and the enforcement actions of supervisors that is not available from other sources. I will give my opinion on whether the paper draws the correct lessons for the future from the history of the 1980s.

Conclusions about Banking in the 1980s

I agree with most of the conclusions in the paper:

- Among banks examined frequently, CAMEL ratings were accurate indicators of problems at most of the banks that failed.
- CAMEL ratings were less reliable indicators of the condition of banks examined less frequently.¹
- The behavior of most of the banks that supervisors identified as troubled banks was consistent with that desired by the supervisors: these banks reduced their assets and dividend rates. In general, banks did not take the kinds of actions that supervisors associate with greater risk after the supervisors had identified their problems.²

* The author is Vice President at the Federal Reserve Bank of St. Louis. The views expressed are those of the author, and do not necessarily reflect those of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

¹ These first two conclusions are consistent with those of my studies of bank examinations; see Gilbert (1993, 1994).

² For other evidence on this point, see Gilbert (1991).

- In most cases supervisors acted to restrict the behavior of troubled banks before they would have been required to act under the scheme for prompt corrective action in FDICIA, which became law in 1991.³
- If the requirement in FDICIA for early closure of critically undercapitalized banks had been imposed during the 1980s, the cost savings of the FDIC would have been small relative to total resolution costs during that period.

Estimating the Cost of Delayed Closure

I have some additional comments on the last point about the costs to the FDIC of letting critically undercapitalized banks remain in operation. First, the results of one of my studies do not support the argument that FDIC resolution costs were positively related to the length of time that banks operated with relatively low capital ratios prior to their failure (Gilbert [1992]). Second, I have reasons to believe that the estimate in the FDIC's paper overstates the costs to the FDIC of permitting critically undercapitalized banks to remain in operation beyond the period permitted in FDICIA.

The FDIC estimates this cost for each of the critically undercapitalized banks that eventually failed by summing its operating expenses and the excess of its funding costs over yields on Treasury securities for the period it remained in operation beyond that permitted under FDICIA. This extra period was not long for most of the 340 critically undercapitalized banks that eventually failed; the median period was two quarters.

It is likely that many of these 340 banks were closed under arrangements that involved bids from other banks for their assets or uninsured deposits, since most resolutions during this period involved such bids (see Bovenzi and Muldoon [1990]). Resolutions that involved bids from other banks generally were less costly to the FDIC (see Bovenzi and Murton [1988] and Gilbert [1992]) but take more time to arrange than closing failed banks and making payments to their insured depositors. During much of the 1980s, the staffs of the bank supervisory agencies had difficulty keeping pace with the rate of bank closings. Earlier closure of these 340 banks, therefore, probably would have required more failed-bank cases to be resolved by closing the banks and paying their insured deposit liabilities. Thus, in the environment of the 1980s, when the number of banks in terminal financial condition was taxing the ability of supervisors to arrange orderly resolu-

³ See Peek and Rosengren (1996b, 1997) for more evidence.

tions, earlier closure of critically undercapitalized banks that eventually failed probably would not have saved the FDIC as much as the paper estimated.

Effects of Formal Enforcement Actions

Another conclusion of the FDIC paper is that formal enforcement actions had about the same effects on the behavior of problem banks as informal actions. Table 1 presents some of the FDIC's evidence, which contrasts the growth rates in total assets, dividend rates and capital injections for the problem banks subject to formal and informal enforcement actions.⁴ Since these measures of behavior were about the same for the two groups of banks, the paper concludes that the step of imposing formal enforcement actions on problem banks had no effect on their behavior.

I do not find the evidence convincing. Some of my concerns involve measurement issues. One measurement issue involves the timing of the formal enforcement actions. The FDIC provides no information on the timing of the formal enforcement actions relative to these periods in Table 1 of three years, two years and one year prior to failure. To illustrate the problem, suppose no formal enforcement actions were imposed on the problem banks as early as three years prior to their failure. In that case, we would not expect significant effects of formal enforcement actions on the behavior of problem banks three years prior to their failure.

The choice of denominator for the dividends ratio probably amplifies noise in the observations, another type of measurement problem. Net income tends to be more variable over time for problem banks than for other banks, with large drops in the net income of problem banks, or possibly losses, in the quarters when they make large provisions for loan losses. High variance in the ratios of dividends to net income tends to reduce the statistical significance of differences between the means of dividends ratios for the two groups of banks. Total assets would be a better denominator for the dividends ratio.

Another concern about inferences drawn from Table 1 involves an assumption implicit in the design of the table that supervisors distributed formal enforcement actions randomly among problem banks. I have an alternative assumption about how supervisors determined which banks were subjected to formal en-

⁴ Readers should note that in Chapter 12 in volume 1 of this study the manner in which these data are presented has been changed; some changes have also been made in the way the data are calculated (FDIC's note).

Table 1
**The Effects of FDIC Enforcement Actions Upon the Asset Growth Rates,
 Dividend Payments and Capital Injections of FDIC Problem Banks
 1980-1994**

(Problem banks: those with CAMEL ratings of 4 or 5)

Years Prior to Failure	Failed banks subject to formal enforcement actions	
	Yes	No
Percentage change in total assets		
3 years	14.81 %	10.29 %
2 years	1.90	3.97*
1 year	-6.83	-7.85
Dividends as percentage of net income		
3 years	21.12 %	34.37 %
2 years	7.58	74.20
1 year	2.54	-3.53
Capital Injections as percentage of total assets		
3 years	0.33 %	0.48 %
2 years	0.45	0.39
1 year	0.39	0.38

* Difference in mean statistically significant at the 5 percent level.

forcement actions: those that exhibited relatively poor compliance with informal enforcement actions became subject to formal actions. Some observations in the FDIC's paper are consistent with my assumption. About half of the problem banks were subjected to formal actions. The median period between the date of the examination when a bank was rated CAMEL 4 or 5 and the effective date of a formal enforcement action was about two-thirds of a year. Thus, FDIC supervisors were selective in imposing formal enforcement actions, and they took a long time to decide which banks would be subjected to the formal actions.

Suppose supervisors judged the compliance of problem banks with informal enforcement actions in terms of their asset growth, dividends and capital injections. If so, we should measure the effects of formal enforcement actions by focusing on these measures for problem banks before and after they were subjected to formal enforcement actions. Peek and Rosengren (1995a 1995b, 1996a), who use this approach, find significant effects of formal enforcement actions on bank behavior.

Lessons for the Future

I draw the following lessons for the future from the history of the 1980s:

- Maintain the schedule of on-site examinations.
- While some improvement of examination procedures may be possible, it is not necessary to make radical changes in examinations to provide supervisors with reliable information on the condition of banks.
- Since supervisors act more promptly in dealing with troubled banks than required by the prompt corrective action provisions of FDICIA, this legislation has not eliminated the need for supervisors to exercise judgment in using their powers. Supervisors will continue to be criticized for the way they exercise their judgment: at times accused of forbearance, and at other times accused of being overly restrictive.
- Implementation of supervision as required in FDICIA will not eliminate losses to the FDIC fund in the future.

It is important that public officials outside of supervision become aware of these lessons for the future. It would be unfortunate if, during a future period of problems in the banking industry, supervisors are distracted from their work by having to explain to public officials why they are exercising judgment, and why bank failures are imposing losses on the deposit insurance fund.

The paper presented by Hanc (FDIC, 1997b) deals with the most important challenge for supervision at this time: limiting the risk assumed by banks when they are profitable and classified as “well capitalized.” The experience of the 1980s indicates that over time large losses and failures reflect risks assumed by banks when their profits and capital ratios made them appear financially strong.

Supervisors are modifying examination procedures to focus on risk management. New examination procedures, however, do not provide supervisors with the will to use their powers to limit the risk assumed by banks while they are profitable and well capitalized. Unless supervisors are effective in developing these procedures and effective in using them to limit risk, they will have failed to respond to the most important lesson of the 1980s.

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Comment on “Bank Examination and Enforcement, 1980-1994”

Joe Peek*

Even though a number of studies have looked at regulatory intervention and many more have investigated bank failures, we still do not understand nearly as much about the process as we could, and should. That is why I view the “History of the Eighties” project as an important contribution. The FDIC has undertaken the first (and most important) step: constructing a comprehensive database that merges heretofore incompatible data sets of examiner information, regulatory actions, and bank balance sheet and income statement information, and then turning their research staff loose on it to see what they could learn. Chairman Helfer took the well-worn phrase “It’s a dirty job, but someone has to do it” and, unlike most other people, did not implicitly replace the word “someone” with “someone else.” The result is a much-needed public service, and I applaud the FDIC for their efforts.

This project has also taken a necessary second step, promoting the interaction of two separate divisions within the regulatory agency, the examination and supervision division and the research division. These two groups, both at the FDIC and at the other bank regulatory agencies, traditionally have had only limited access to the expertise and information of the other. Certainly, they can learn much from each other.

How can we expect to write regulatory legislation and implement that legislation effectively if we do not understand exactly how banks react to intervention, or even the threat of intervention? And, more important, whether that reaction, in fact, reduces the probability of a bank failing, or, should the bank subsequently fail despite regulatory intervention, at least reduces the resolution cost to the FDIC. Increasing the flow of information between the examination and supervision divisions and the research divisions of the bank regulatory agencies has the potential to make substantial improvements in bank examination and enforcement, the topic of the paper under discussion.

* The author is Professor, Department of Economics, Boston College and Visiting Economist, Research Department, Federal Reserve Bank of Boston. The views expressed are those of the author, and do not necessarily reflect official positions of the Federal Reserve Bank of Boston or the Federal Reserve System.

Bank Examination and Enforcement, 1980 to 1994

This study has two main objectives: (1) to provide an historical account and evaluation of bank supervision policies and (2) to assess the effectiveness of bank supervisory tools in limiting losses to the bank insurance fund. The authors have done an admirable job on the first objective, and I presume the findings will be incorporated into their next budget request for additional examiner resources. I certainly agree that there is no substitute for on-site monitoring. In fact, “being there” can only become more important over time as ongoing trends in the banking industry—the movement to off-balance-sheet activities, the movement into nontraditional banking products, and the geographic expansion of operations, both domestically and globally—further complicate the lives of those in the supervision and regulation division.

With respect to the second component of the study, I find most of the results quite believable, in large part because they line up quite closely with the evidence that Eric Rosengren and I have found in a number of our studies. For example:

1. On-site exams are valuable for providing information to regulators and for maintaining the integrity of reported data. This result also confirms the findings in a series of papers by another member of the panel, Alton Gilbert.
2. On-site exams were reasonably effective in identifying troubled banks (Peek and Rosengren [1996]).
3. Prompt Corrective Action, as now implemented, is unlikely to impose much of a constraint on supervisory intervention; formal actions tend to be imposed well before most banks become undercapitalized according to PCA capital thresholds (Peek and Rosengren [1997]).

In addition, the study’s suggestion that developments in the regional and national economy that could pose future problems be incorporated into failure models and into the exam process is on the right track.

On the other hand, I would be more reserved in my interpretation of the results with respect to the effectiveness of regulatory intervention. However, to paraphrase a line from the study’s summary, these comments do not represent criticisms, but only serve to point out limitations to the analysis.

The analysis of the effectiveness of regulatory intervention should be broken into two separate questions. First, was regulatory intervention effective in chang-

ing bank behavior? And second, did that change in bank behavior reduce the probability of failure, or at least reduce the cost to the FDIC from those banks that did eventually fail? On the first issue, the authors find no consistent differences in asset growth rates between problem banks (rated CAMEL 4 or 5) that did receive formal actions and problem banks that did not. Yet, in considering the second issue, they suggest that regulatory intervention has been effective. They argue that essentially all problem banks are subject to intervention, so perhaps their result is really just telling us that informal intervention (in the form of a memorandum of understanding—MOU) is no less effective than a formal action.

In contrast, Eric Rosengren and I (Peek and Rosengren [1995]) have found fairly strong evidence that the imposition of formal regulatory actions—cease-and-desist orders and written agreements—did have an immediate and dramatic effect on loan and asset growth at banks in New England during the recent banking crisis. Since then, we have expanded our database to include banks nationwide and the results hold up, so that it was not simply a New England phenomenon. And these results are obtained while controlling for bank-specific characteristics, including measures of bank health.

The difference in our results may be related to a difference in the bank sample (all FDIC-regulated banks compared to our sample of all New England banks), but is more likely due to differences in methodology. The FDIC study uses the failure date or recovery date as the point of reference, while we use the date of the exam that resulted in the formal action as our reference point. I believe that the proper test is to treat the imposition of a formal action as an event, comparing bank behavior immediately before and after the event. Only in this way can one really determine whether the event had an effect on bank behavior. In any case, it is interesting that even though Eric and I appear to find the stronger evidence that regulatory intervention changed bank behavior, we remain much more agnostic about whether this intervention is effective in terms of reducing risk-taking and bank failures.

Changing bank behavior is one thing. But it is a very different question whether the regulatory intervention was effective in changing bank behavior in a way that reduced the number of bank failures, reduced the losses to the deposit insurance fund, or reduced the risk-taking at troubled banks—although I believe that to the extent intermediaries did make second bets, it was more a savings and loan than a commercial bank phenomenon.

Early intervention assumes that if the problem is caught early and the bank alters its behavior, it may be possible to reverse the bank's decline. However, to date, little definitive empirical evidence on this point has been produced. Such evidence is very important, insofar as we need to know the extent to which a trade-off exists between the costs to bank loan customers due to bank shrinkage and the benefits to the FDIC (and hence taxpayers) of reduced costs of bank failures. It is possible that bank survival is determined primarily by economic factors unrelated to regulatory intervention, in which case the shrinkage of bank assets in response to regulatory actions may have little or no effect on the probability of a bank's survival. As the authors acknowledge, while the recovery of many banks is consistent with positive results from regulatory intervention, we cannot be sure about the extent to which any recovery in bank health can be attributed to management, stockholders, market forces, or bank supervisors.

With the information that we have available, we cannot yet distinguish whether the bank shrinkage that resulted from regulatory intervention was analogous to sending in the leeches for a round of bloodletting—an analogy that many bankers may find appealing—or did, in fact, cause banks to take on less risk and get their houses in order. Certainly, when it comes time to shrink, troubled assets are the least marketable, so one could imagine that the shrinkage occurs disproportionately through the sale of the better-quality assets that can fetch a price closer to book value. Consequently, the remaining portfolio may be more, rather than less, risky.

In terms of prompt corrective action, we can answer the question of whether intervention has been prompt. But we are still some distance away from being able to answer the question of whether intervention has been corrective. However, the construction of the expanded panel data set that is the heart of the “History of the Eighties” project will greatly increase the range of regulatory actions and bank reactions that can be examined carefully and in depth. The resulting research should provide an empirical basis for understanding the impact of intervention provisions such as those in FDICIA, enabling policymakers to make much more precise inferences about how different types of bank regulation affect both bank behavior and performance.

The role of regulatory intervention has been largely ignored in most failure studies. We need to look not only at those banks that failed, but at those that recovered, and see if we can develop an understanding of those factors that contributed to their recovery. Did those banks recover because of supervisory

intervention, or in spite of the intervention? Does recovery depend on initial conditions, for example, the bank's health at the time of the formal regulatory action? Thus, how important is the promptness of the intervention and the speed at which the bank's health is deteriorating? Is there a point of no return and, if so, what is it? Is it really a 2 percent tangible capital ratio? Do differences in bank reactions to supervisory intervention really make a difference? What role do local economic conditions play in the probability of a troubled bank recovering? What it comes down to is this: Once a bank is identified as troubled, is there still time, and a method, to reduce its probability of failure by a meaningful amount?

Conclusion and Recommendations

Bank regulatory policies have been proposed, enacted, and implemented with laudable intentions, but little clear understanding of their positive or negative consequences. To some degree, regulatory legislation and policy have been based on economic theory, and even more often, on economic theology, assumptions, guesses, and wishful thinking; but rarely have they been based on solid evidence—because the evidence was not available. This omission was a direct consequence of our failure to construct a comprehensive database with which we could ask, and answer with confidence, the important questions concerning how regulatory intervention works, whether it accomplishes what is intended, and how it can be made more effective. That such a database had not been constructed is not particularly surprising when one thinks about the focus of examiners, the ones with the data; they are interested in today and tomorrow, not the past. Only research economists have the luxury of sitting back and doing retrospective studies.

To design and implement sensible regulatory policies, we need to learn the extent to which our good intentions have, in fact, become outcomes. The “History of the Eighties” project is an important first step in providing the evidence that can make regulatory intervention and policy more effective, but it is only a first step. We need to continue these efforts to provide a comprehensive database with which researchers can carefully investigate the role and consequences of regulatory policy. And we must continue to encourage the commingling of examiner and research resources. The whole is far greater than the sum of the parts.

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Comments on Bank Examination and Enforcement

Stephen R. Steinbrink*

I find myself largely in agreement with the lessons of the eighties that are in the study, but would like to make several comments regarding them. Then I will move on to discuss some other issues that I believe might be important as the regulatory agencies go forward. Now that I have retired and it won't seem self-serving, I do want to mention that the regulatory agencies have a very difficult job, particularly from the standpoint that it is a given that they are going to be criticized regardless of what they do. So, they might just as well be happy being criticized.

The first lesson of the eighties that was listed in the paper was that reduction in resources didn't work. A few points should be added to that general statement. First, you need to realize that the reduction of resources occurred during a period when the number and the size of the institutions were expanding dramatically. My experience in this area during this time was almost entirely in the Southwest District of the Office of the Comptroller of the Currency. It should be pointed out that there was never a policy in the Comptroller's office to reduce the number of resources in the Southwest District. There were, however, reductions due to circumstances. The District had over a 20 percent turnover rate, and there were nationwide hiring freezes as a result of the administration's desire to reduce government in general. These circumstances thrust the Southwest District—when the hiring freezes were in effect—into having to hire very carefully to try to bring on just enough staff so that there were experienced examiners to train them and still accomplish on-site examinations during the time. It should be noted that almost all examiner training is on-site in the bank and not in the classroom.

Because of that reduction in resources, there were fewer examinations and a less experienced staff; there is no doubt that this hindered the identification of problem banks. At present, however, if you were to look at the statistics (though I have been gone from the OCC almost a year now), I believe almost 80 percent of the staff of the OCC consists of Commissioned National Bank Examiners, which means that they have been on the job approximately five years, and probably more than five years. So, there is now a lot of experience in the regulatory agencies.

* The author was Senior Deputy Comptroller of the Currency for Bank Supervision, Office of the Comptroller of the Currency, from March 1993 to May 1996 and from July 1991 to February 1992.

I would nominate as a second lesson, that there has to be some effort to merge “economic information” and “examiner information” within the examination process. All the agencies have tried this for some time, but with only limited overall success. Let us consider an example of why this would be important. If you were a bank examiner in Texas in the 1980s, and you went to a board of directors to discuss problems in real estate that had not yet been specifically identified (in other words, it was possible to see concentrations and potential for problems in the future), it was likely that half of that board consisted of real estate developers. They were not going to believe you when you said that their industry was heading down a path that perhaps they ought to step back and assess. If you could have gone to them with some sort of economic information, along with your examining skills, then you would have had a much better chance of changing their minds or perhaps getting them to be thoughtful about the process. You would hopefully have been more effective in that regard. It strikes me that if we do not do that, all the examiners and all the examinations are probably for naught. We must give the examiners the skills to have an impact on what is affecting those banks day-in, day-out in their operations and in their competition. I believe this is a crucial point. All the regulators right now are working on doing this, although they are using different methods, and are having different levels of success.

I will certainly agree that on-site examinations are extremely important. Off-site examinations are also very beneficial. During interim periods, they can increase the efficiency of the process. They can assist in the scheduling and conducting of exams. But despite all that, it remains necessary to go into the institution and look somebody in the eye and discuss the problems that exist in the bank, or even just to ask a question and evaluate the response. There are also some very practical reasons for on-site examinations, particularly in small institutions. First, a small institution is paying something and they deserve something back. Second, some of the small institutions actually consider the examination important as a third-party view of their work. Finally, the fact of the matter is that the simple presence of an examiner serves as a discipline and that is beneficial to the process.

With regard to the rating systems, the agencies have wanted to make those systems forward-looking. We have tried and tried and, to be honest, haven't been very successful at it. There have been isolated instances where the ratings systems have been forward-looking, but those have been very few. I believe, however, that

within the last year, each of the regulatory agencies has discussed a process that while it did not involve new rating systems, did result in supplements to the rating system, and that is the new discussion of risk. I think that is in response to the lessons learned in the 1980s, at least to some extent. In the Comptroller of the Currency's risk management publications, there is actually reference to assessing the direction of risk, which I believe directly addresses the concern regarding looking forward, and that is identifying where the risk is headed and looking toward the future. I guess the vote will still be out as to whether that ends up being successful. I know before I left, and I'm sure it is still going on, that everybody is working on that.

As to enforcement actions, the paper indicates, given what was studied, that there was not a large distinction between formal and informal actions as to what happened to improve the conditions of the institutions. I am not sure that I agree with that conclusion, but do not have any real basis for disagreeing with it. The point I would make about enforcement actions, and in some respects this agrees with the paper, is that the document is not nearly as important as the presentation of the document by the regulatory agency, because when you present the document to the bank, your goal is to get their attention. In most cases, the bankers go through a period of denial where they believe that the regulator is just not seeing the institution in the right light. If you are effective in presenting the facts, then you get the bank and the board's attention. The bank and board take action—sometimes immediately—to deal with whatever problems exist. I am not talking about banks that are going to fail in a week. But, if you are dealing with a bank that has a problem that could lead to potential failure two years later and you get their attention and they take immediate action, when you go to the bank 3-4 months afterward with a document, everybody will sign it, but will also indicate that they have already taken action.

The fact is, that if the examiner, at least at the OCC, is doing his or her job properly, then the day they leave the bank, the day they have an exit meeting, they should have told that institution everything that will be in the document when it finally comes. If the bank accepts that fact and starts action, then by the time the supervisors get the document processed, you are presumably a long way down the road toward corrective action. However, there are many times you just do not get corrective action. I was disappointed that the OCC's enforcement actions were not given to the authors of the study, but while I don't have the statistics in front of me, if my recollection serves me properly, at one point I think about 80 percent

of all national banks in the United States had some sort of action, and probably at least half of those were formal.

The next to last issue I wanted to mention was Prompt Corrective Action (PCA), about which there has been much debate. Some like it; some do not; I am ambivalent. One former chairman of the FDIC made the statement that there will come a time when we could regret the regulatory agencies having been put in a position of having to close banks that did not need to fail. I can see that argument, but I would temper that statement just slightly. In my experience with the large bank population, and I don't know if this was the intent of PCA, but when FDICIA was implemented and the capital ratios were finally established, managements and boards immediately began to take action to ensure that their institutions would never be affected by PCA. Now, regulators always like to take credit for things but we did not have a thing to do with that action. The reason those capital relationships went up was only because they didn't want their stock to be affected by their capital proximity to PCA. It was driven totally by their worry about the stock market and Wall Street. They therefore raised capital, and that is probably a good thing. Overall, I do not believe that PCA was a bad law, although some of its provisions are a little draconian. As a practical matter, however, if you go back and look at the enforcement documents, there is nothing in PCA that isn't in most of them, perhaps with the exception of the removal of directors, which was not a common practice.

Finally, in the paper there is a reference to the delay in the closure of banks. I am always sensitive to that because a lot of them were OCC banks. When you look at how long it took to close a bank and you look to the comparison of PCA, it is very important to remember a regulation—because of the definitions of capital, the OCC, until year-end 1989, had to charge off every dollar of capital and every dollar of the allowance for loan and lease losses before a bank could be declared insolvent. This had a dramatic impact on national banks, because many states had a different capital definition whereby they could close a bank based on viability. This regulation had a significant impact on the OCC.

In addition, I should note that I participated in establishing a very elaborate process for reviewing banks that were going to be declared insolvent. Examiners would perform the examination, would come up with losses, and would preliminarily find the bank insolvent. Then the line sheets were brought into the District office, just to be certain that they were correct. If it was a sufficiently significant bank, they might have been brought to the Washington office. I personally sat

down and reviewed line sheets when I was the Senior Deputy Controller because I always thought that closing a bank was a really important issue. When you have sat down with a board of directors and closed a bank, you can see the impact it has on the individuals sitting in that room, who sometimes have their entire net worth wrapped up in that bank stock. I wanted to make damn sure that we did it right.