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An Examination of the Federal Deposit Insurance Corporation Improvement Act of 1991

by

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An Examination of the Federal Deposit Insurance Corporation Improvement Act of 1991

Charles R.B. Stowe, Keith Jenkins, and Donald R. Brown*
Sam Houston State University

Some Congressional critics have expressed disappointment over Congress's failure to pass a comprehensive bank reform act. A close examination of the Federal Deposit Insurance Corporation Improvement Act of 1991 suggests that Congress passed a comprehensive regulatory scheme that gives the Federal Deposit Insurance Corporation and other federal agencies new powers to regulate banks. The Act prescribes a new framework for reporting financial activities. The Act also gives federal agencies the mandate to restrict financial strategies that Congress felt were responsible for the banking failures of the 1980's. Under the new Act, bank management's decisions related to the financial structure of the loan portfolio, loans to insiders and even executive compensation may come under federal regulation. A review of the FDIC Improvement Act reveals a legislative philosophy of bank regulation that carries significant implications for the banking industry.

While federal agencies are still in the process of developing specific regulations in accordance with Congressional mandates of the Act, an examination of the Act suggests an entirely new regulatory framework. This legislation is the Gold Card of regulatory authority for all federal agencies involved in the regulation of banking. The distinguishing feature of the FDIC Improvement Act is that it empowers federal regulators to write regulations that restrict strategies for maintaining compliance with Federal Reserve capital requirements. The Act is philosophically consistent with risk-based capital requirement standards. While past regulations essentially leave banks free to develop their own portfolios based on their own assessments of risk, the new Act requires that federal agencies categorize banks according to the composition of their loan portfolio. Under this new regulatory scheme, the weaker the bank's loan portfolio, the more intrusive the regulations on bank activities. The act requires that appropriate federal agencies develop uniform standards for lending.

While titled the Federal Deposit Insurance Corporation Improvement Act of 1991, the act contains a basket of new standards to be developed and implemented not only by the Federal Deposit Insurance Corporation but by other federal agencies that regulate the banking industry. Banks that fall in the lower tier will find themselves subject to preemptive regulatory supervision and new restrictions on their financial strategies even to the point of yet to be developed standards of executive compensation. The regulatory
framework leaves no area of bank management decision-making immune from regulation if the bank falls into a "risk" category. Bankers retain the power to decide on individual loans except for loans to "insiders". However, the new regulations impose guidelines on the overall composition of a bank's investment portfolio. The regulations cover a wide range of bank activities ranging from the solicitation of brokered funds to the criteria for making real estate loans. The statute requires different agencies to develop specific regulations consistent with the Act. At this writing, many agencies have not issued final regulations on all aspects of the Act. A review of the act and those regulations that have been issued should be valuable to bankers who are obligated to integrate the rules into their corporate strategy and internal management/decision making structure. This review of the Act assists finance students and professors understand the regulatory environment and philosophy that will impact this industry for a long time.

History

Congress passed the Banking Act of 1933 in response to the economic depression and failure of over 15,000 banks filed between 1920 and 1933. Between 1930 and 1932, 5,000 banks failed. The 1933 act set up the current system of bank reserve deposits. The Act also provided for a system of insured deposits (starting in 1933 at $2,500), froze bank expansions, stopped commercial banks from participating in the equity markets and regulated the rates that banks were able to pay for funds deposited.

In the late 1970's there were major changes in the economic market place in part attributable to the "deregelation" of the thrift industry. Under the climate of deregulation, other institutions offered competing accounts similar to traditional bank deposits. In 1982 the Garn-St. Germain Act permitted thrifts to compete directly against traditional banks by permitting thrifts to make loans to agricultural, corporate and commercial enterprises. Another change was the increased competition from foreign banks operating in the United States. During the ten year period between 1976 and 1986, foreign bank activity in the United States increased over 200 percent. The Tax Reform Act of 1980 increased the benefits of capital gains and accelerated depreciation schedules. Lower capital gains rates and higher deductibility of depreciation were two strong incentives for investing in real estate projects. In addition, with the reduction of inflation, investors and depositors looked for relatively safe (deposit insurance provides this safety) places to invest funds and still reap competitive yields.

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Wall Street responded to changes of the economic environment during the early 1980s by creating financing alternatives to conventional commercial loans. The "junk" bond movement followed a period of deflation. After earning high yields during inflation, institutional investment managers were under pressure to achieve superior yields to maintain the healthy yields they had achieved during the preceding inflationary period. The junk bond market offered companies a way to obtain highly levered loans that banks would have refused to make under conventional banking practices. Investors were eager to purchase junk bonds because they provided a higher return than CDs. While junk bond interest rates were high, companies found that with the double taxation of dividends, it was cost effective to issue bonds over the expenses and dilution of ownership involved with selling equity. Corporations used the cash raised from junk bonds to purchase other companies, pay extraordinarily high dividends to existing shareholders or to finance leveraged buyouts. Junk bond dealers arranged private debt financing as eager institutional fund managers bought more junk bonds to show a high yield on their fund's portfolios. Many nationally known firms used junk bond financing including NJR Nabisco the cookie company; Harcourt Bracewell Jovanovich the college and school textbook company, and Chiquita Banana's.

These factors all lead banks to making more loans to less credit worthy borrowers. So, banks saw an opportunity to lend money to real estate developers many of whom relied on the collateral of their real estate projects for their loans. Many real estate developers bought interests in financial institutions and then used those same institutions to bankroll further projects. The real estate industry boomed during the first half of the 1980s. Supply of real estate projects both commercial and residential exceeded a normal five year supply in several cities. The oil producing states were first to feel the real estate bust due to the decline in oil prices and resulting layoffs. The Tax Reform Act of 1986 designed to "close the loopholes on the rich" according to U.S. Senator Lloyd Benson coupled with a recession in the oil industry which affected the real estate boom in the oil producing states lead to bank and savings and loan failures. During the 1970's only 76 banks failed compared to nearly 1,000 in the 1980s. In 1988, there were 221 failures with 1,100 additional banks classified by the Federal Deposit Insurance Corporation as "troubled". By 1991, the Federal Deposit Insurance Corporation was almost broke as a result of all the bank failures. Between September 30, 1991 and January 31, 1992, there was a 26% rise to 613 billion in dollar assets of the FDIC's secret problem bank and thrift list.2

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The Federal Deposit Insurance Corporation Improvement Act

There are two objectives behind the Act: one is to promote rapid intervention and the second is to define a stricter criteria for determining the economic health of banks. Congressional testimony and media reports stressed that the failure of regulators to move in on banks with a deteriorating capital structure added to the final cost of the taxpayer bailout of the Federal Deposit Insurance Corporation. To encourage faster intervention by federal authorities, the Act defines a system that requires intervention if a bank falls into certain risk based capital categories. Both the legislative history and the language of the bill make it clear that the intent of the act is to limit losses to the FDIC through early intervention. There are essentially four major activities that Congress determined were in need of regulation to avoid a repetition of the bank failures of the 1980's.

The first topic we will examine deals with early intervention. Congress decided to deal with the issue that federal regulators did not intervene quickly enough against banks with declining capital structures. The irony is that many Congressional leaders intervened on the part of savings and loans to delay regulator intervention. Part of the difficulty was that regulators were unable to determine the extent the risk of bank failure based on a single reporting of the bank's overall capital and loan structure. Regulators did not have either the regulatory authority or framework to analyze declining capital structures of banks. The regulatory framework for reporting financial data requires banks to furnish "call" reports. Call reports did not provide the detail on varying amounts of risk in a bank's portfolio of assets.

In an earlier action, Congress mandated the creation of the Federal Reserve Bank Risk-Based Capital requirements. The FDIC Improvement Act carries this regulatory philosophy to the area of requiring federal regulatory agencies to impose harsher standards on banks that fall into weak capital categories. The goal of early intervention is to restrict banks from practices which tended only to delay and magnify eventual losses to the FDIC. In Congress's opinion, delays increased the ultimate expense of the bailout to the taxpayer.

Sour loans due an overbuilt real estate market placed many lending institutions in financial jeopardy. In so much as many of the non-performing loans were attributable to

3 See articles on the "Keating Five" controversy where five U.S. Senators met with Charles Keating, President of Lincoln Savings and Loan in an attempt to delay federal intervention when real estate projects in California and Arizona resulted in huge cost overruns and delays that jeopardized any realistic cash flow sufficient to continue to classify the loans as performing loans. Some commentators like the editorial pages of the Wall Street Journal were highly critical of Congressional influence used to thwart early intervention by federal regulators.
real estate projects, Congress set up a requirement that banks use a uniform criteria for lending to the real estate industry. Traditionally, lending institutions base their real estate lending decisions on appraisal made by third party appraisers. Many of the appraisals made during the real estate boom turned out to be too optimistic. The Act reflects Congresses concern over the licensing and qualifications of those who provide lending institutions with appraisals.4

The entry of foreign banks into the U.S. market increased competition in the U.S. banking industry. Foreign banks that enjoyed a lower cost of funds aggressively competed to lend to the same potential borrowers as U.S. banks. Increased competition seemed to result in more loans to less credit worthy borrowers. The Act contains provisions designed to place U.S. and foreign banks operating in the U.S. under the same regulatory burden.

One other factor that increased the financial burden to the Federal Deposit Insurance Corporation and ultimately the U.S. taxpayer was the practice of brokering deposit accounts. Independent brokers solicited banks willing to pay the highest interest rates on insured deposits. These brokers would then place these funds into banks seeking to increase their capital by making additional loans. The newly acquired brokered funds gave banks the means to write additional loans. The strategy was that while their bad debts were rising, these could be offset from profits on new loans. Due to the declining fortunes of the oil industry, this practice was widespread among Southwestern banking institutions. Their willingness to pay higher interest rates resulted in additional "brokered" deposits which for the moment strengthened their ability to make more loans with the possibility of improving their capital base through improved earnings. Another method to increase bank's earnings through loans was to solicit foreign deposits from investors wanting to have the safety of federally insured investments. The brokerage of deposits had the effect of leveraging the bank's capital therefore increasing the ultimate size of the economic catastrophe.

The Act contains provisions that amend many federal statutes and provisions that lie outside addressing the above factors. Rather than reviewing each provision of the act, it is more useful to examine its provisions relative to the four major topics concerns discussed above. The Act mandates sweeping new regulations under a new regulatory

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4 It is interesting to note in the Legislative History that no mention is made of the affect of the 1986 Tax Reform Act on the real estate industry. The 1986 Tax Reform Act changed depreciation schedules and retroactively changed the basic tax incentives for investing in real estate. The creation of "passive income" category for limiting real estate losses to $3,000 per year against ordinary income wiped out a major incentive to invest in real estate. In addition, the 1986 Tax Reform Act eliminated the preferential treatment of capital gains.
philosophy best expressed as an extension of the risk based capital framework developed by the Federal Reserve Board. This new philosophy of regulation bases future regulations on the economic assumption that a bank's portfolio of loans (carried as the bank's assets) entail different levels of risk. As banks cross certain risk thresholds, they deserve every closer regulatory scrutiny.

**Prompt Intervention**

Congress created five capital categories of banks to force regulators to take "prompt corrective action." The five categories are: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. The only category which Congress chose to define was the critically undercapitalized.

On October 1, 1992, the Comptroller of the Currency issued the final rule implementing prompt corrective action and defining the capital categories. As stated in the Federal Register, "To the extent possible, the final rules define capital terms in the same way as they are defined under existing capital adequacy standards." The information used to categorize the banks comes from existing call reports. Additional information comes from the annual audits conducted by appropriate regulators. In the event that a material event occurs that would result in a bank being classified into a lower category, the rules require the banks to give notice. The final rules do not adopt a requirement that institutions calculate capital positions on a daily basis.

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Table 1

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<thead>
<tr>
<th></th>
<th>Well Capitalized</th>
<th>Adequately Capitalized</th>
<th>Under Capitalized</th>
<th>Significantly Undercapitalized</th>
<th>Critically Undercapitalized</th>
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</thead>
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<td>Risk-Adjusted Capital</td>
<td>10%</td>
<td>8%</td>
<td>&gt;6%&lt;8%</td>
<td>&lt;6%</td>
<td>&lt;6%</td>
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<tr>
<td>Required</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk-Adjusted Equity</td>
<td>6%</td>
<td>4%</td>
<td>&gt;3%&lt;4%</td>
<td>&lt;3%</td>
<td>&lt;3%</td>
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<tr>
<td>Capital</td>
<td></td>
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<tr>
<td>Required</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Equity-to-total</td>
<td>5%</td>
<td>3 or 4%</td>
<td>&lt;4%</td>
<td>&gt;2%&lt;3%</td>
<td>2% or less</td>
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<tr>
<td>Assets Required</td>
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<td></td>
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Banks will have to meet three separate tests to determine their capital category. Under this scheme, a bank may score in different categories for each test. If this occurs, the bank will be placed in the highest capital category for which they meet all three tests. Banks that fall into the well capitalized or adequately capitalized categories have the least regulatory restrictions placed on their operations. If a bank falls into one of the lower categories, certain restrictions apply even without direct action by the Comptroller of the Currency. For example, no bank that is undercapitalized may pay a dividend or pay management fees to its controlling owner, and undercapitalized banks must submit capital restoration plans within 45 days of becoming undercapitalized. Under Section 38, the appropriate regulators will inform banks of other restrictions on their operations through Prompt Corrective Action directives.

A "critically undercapitalized" bank is one whose ratio of tangible equity to total assets is set at no less than 2% equity capital and at no more than 65% of the minimum standard. Critical capital would fall between 2% and (4% times 65% for equity as a percent of assets). All four of the other categories will therefore above the critically undercapitalized category. Under the Act, if a bank’s capital falls below 2%, the Federal Deposit Insurance Corporation must act within 90 days. This action can be less drastic.

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than closure for up to 90 day periods, but they must act to close the banks after one year unless the bank makes significant progress. In all cases, if the bank has a negative capital ratio, the regulators must close the institution. For the institutions it closes, the FDIC must use the resolution method which represents the least possible cost to the insurance fund.  

10  The Congressional History goes on to explain that:

The provisions of this legislation that require regulators to take action before a bank becomes insolvent, and then to resolved failed institutions at the least possible cost would eliminate the "too big to fail" policy currently being followed by the FDIC. Since large banks are not necessarily healthier than their smaller counterparts, the Committee believes the FDIC should not use insurance funds to keep them open simply because of their size.  

11  To promote early intervention, Congress set up limitations on executive compensation, operation and management standards, asset quality, earnings and stock value. If a bank becomes significantly undercapitalized or is undercapitalized and fails to submit a capital restoration plan, the bank will be subject to the act that restricts executive compensation of officers:

(4) Senior Executive Officer Compensation Restricted.

(A) In general, the insured depository institution shall not do any of the following without the prior written approval of the appropriate federal banking agency:

(i) Pay any bonus to any senior executive officer.

(ii) provide compensation to any senior executive officer at a rate exceeding that officer's average rate of compensation (excluding bonuses, stock options, and profit sharing) during the twelve calendar months preceding the calendar month in which the institution became undercapitalized.

(B) Failing to submit plan. The appropriate federal banking agency shall not grant any approval under subparagraph (a) with respect to an institution that has failed to submit an acceptable capital restoration plan.  

12  2 Cong. News '91 Bd. Vol., 105 STAT 2260, Federal Deposit Insurance Corporation Improvement Act, Section 131 (f) (4).
Another area that will come under increased federal regulatory scrutiny are loans and overdrafts to executives or "insiders". Congress responded to the concerns that real estate developers used their real estate projects as collateral to purchase shares of thrift institutions. As board members, the real estate developers encouraged their institutions to extend more credit to them to build more real estate projects. The statute sets forth an aggregate limitation of extensions of credit to insiders. The limitation is the amount that would not exceed the bank's unimpaired capital and unpaired surplus. The Act contains a provision that permits the Board to have less stringent limitations for institutions with less than one hundred million in assets. The Act cites two reasons for this exception for smaller institutions. Smaller institutions need some latitude to attract investor-board members. In smaller communities the most likely investors are local citizens. Overly restrictive policies might deter investors and therefore unduly restrict capital to small communities.

The Act requires that the appropriate federal banking agencies issue operational and managerial standards on internal controls, loan documentation, and credit underwriting. Regulations will cover interest rate exposure, and asset growth. The severity of regulations differ depending on the capital category the bank falls into. The philosophy behind this scheme is that the healthier banks will have more freedom to manage their assets while the less capitalized banks will face increasingly harsh restrictions on their actions. Troubled banks will no longer have the freedom to engage in practices gambling on future profits on loans to strengthen their capital base.

(B) Asset quality, earnings, and stock valuation standards. Each appropriate federal banking agency shall for all insured depository institutions and depository institution holding companies prescribe:

(1) Standards specifying -

(A) A maximum ratio of classified assets to capital;

(B) Minimum earnings sufficient to absorb losses without impairing capital; and

(C) to the extent feasible, a minimum ratio of market value to book value for publicly traded shares of the institution or company; and

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13 See Section 306 of the Act for the definition of "insiders".
(2) such other standards relating to asset quality, earnings, and valuation as the agency determines to be appropriate.\textsuperscript{16}

Even more intriguing is the mandate that federal agencies set standards of executive compensation that are designed to prevent "excessive compensation, perquisites, post-employment benefits and stock option plans that would lead to material financial loss to the financial institution."\textsuperscript{17} These executive compensation standards will apply to all banks regardless of the capital category they fall into. This standard grants federal regulators a seat on the board of directors of every financial institution under their regulation by vesting the power to set standards of compensation.

The Act recognizes that bank accounting reporting system does not provide federal regulators with the detail necessary to carry out the regulatory mandate. Of particular interest to proponents of small business, minority owned enterprises and small farms is the requirement of Section 122 of the Act that calls for "FDIC institutions with assets of more than $100 million to include in their reports of condition (call reports) a breakdown of commercial lending activity in a manner that would give the regulatory agencies and the public a clearer picture of loans to various categories of small businesses, ..." Currently, banks report commercial and industrial loans as a single broad loan category without a separate sub-category for small business loans.\textsuperscript{18} The new provision permits researchers to evaluate the impact of federal regulations on commercial loans to small businesses as some have concluded that bank lending to small business may have decreased under the Federal Reserve Risk-Based Capital requirements.\textsuperscript{19} Recently, the government has backed away from a detailed reporting system in announcing that call reports would simply require a showing of loans under $1 million. Such a simplified reporting requirement does little to reveal the true impact of the new regulations on lending to small institutions. It is entirely possible that relatively small loans to very large corporations could be reported under this system.\textsuperscript{20}

\textsuperscript{16} 2 Cong. News 91 Bd. Vol., 105 STAT 2260, Federal Deposit Insurance Corporation Improvement Act, Section 132 (b).
\textsuperscript{17} 2 Cong. News 91 Bd. Vol., 105 STAT 2260, Federal Deposit Insurance Corporation Improvement Act, Section 132 (c).
\textsuperscript{20} Federal Register, Vol. 57, No. 189, Tuesday, September 29, 1992, p. 44896.
Notice and Procedures

The final rules issued by the Comptroller of the Currency requires that the appropriate agency will provide written notice to an institution or company prior to issuing a directive. The notice will include the action contemplated by the agency. The bank has a minimum of 14 days in which to submit written arguments and evidence in response to the proposed agency action. Failure to respond within 14 days constitutes an automatic waiver of the opportunity to appeal. The agency is required to consider the response and must give a final answer within 60 days. The final rule states that "The agencies reserve the right to issues directives that are effective immediately when the circumstances of a particular case indicated that immediate action is necessary to serve the purpose of prompt corrective action. In these cases the final rules provide the institution an opportunity to seek modification or rescission of the directive on an expedited basis."21 The rule explains that any institution that appeals an immediately effective directive is required to file a written appeal within 14 days and the agency must consider the appeal within 60 days of receiving it.22

If an agency directs the dismissal of directors or senior executive officers, the institution may obtain a review of the dismissal by filing within ten days, a petition for reinstatement. This procedures permits an opportunity for an oral hearing subject to the approval of the hearing officer whereas the rule on appealing PCAs (Prompt Corrective Action directives) does not offer an opportunity for oral presentations. The rule does not, however, grant an absolute right to an oral hearing. In petitioning the agency to reverse their directive, the institution must prove that the reinstatement of the dismissed individual(s) would "materially strengthen the institution's ability to correct the condition or practice."23

If a bank is placed in either the undercapitalized, significantly undercapitalized, or critically undercapitalized categories, it must file a capital restoration plan with the proper federal agency within 45 days. Failure to submit a capital restoration plan results in immediate reclassification of the institution as critically undercapitalized. Critically undercapitalized institutions are placed in conservatorship or receivership within 90 days unless the FDIC determines that some other action better serves the purposes of the Act. The commentary to the rules suggest that during the period the institution is working on their capital restoration plans, they should be in constant discussion with the appropriate

23 Op. Cit. p. 44875
agency. The purpose of the continued discussions is to insure that the institution will submit a capital restoration plan that the regulators will accept.24

The format for the capital restoration plan is as follows:

(1) The steps the institution will take to become adequately capitalized;
(2) The levels of capital the institution expects to attain in each year that the plan is in effect;
(3) How the institution will comply with the restrictions and requirements imposed on the institution under section 38;
(4) The types and levels of activities in which the institution will engage; and
(5) Any other information required by the appropriate Federal banking agency.25

In addition, the capital restoration plan requires a guarantee from each company that controls the bank. The aggregate liability under the required guarantee is the lesser of an amount equal to 5.0 percent of the bank’s total assets at the time the bank was notified or deemed to have notice that the bank was undercapitalized; or the amount necessary to restore the relevant capital measures of the bank to the levels required for the bank to be classified as adequately capitalized. The guarantee expires when the Office of the Comptroller of the Currency notifies the bank that it has remained adequately capitalized for each of four consecutive calendar quarters.26

Uniform Standards for Real Estate Lending

A most intriguing provisions of the FDIC Improvement Act is the uniform standard for real estate lending requirement. The appropriate Federal banking agencies must adopt "uniform regulations prescribing standards for real estate lending by insured depository institutions."27 Section 304 of the Act which amends section 18 of the FDIC Act calls for uniform regulations within nine months. These regulations will prescribe standards for the extension of credit which are collateralized by real estate or by the construction of improvements or building to real estate.28

The statute gives some broad guidelines to the standard. The criteria for setting the future standards "shall give consideration to the risk posed to the deposit insurance funds, the need for sound and safe operation of the insured depository institutions and the availability of credit. No appropriate federal banking agency shall adversely evaluate an

25 12 USC 1817, Federal Deposit Insurance Corporation Improvement Act, Section 38(e)(2).
investment a loan made by an insured depository institution or consider such a loan to be non-performing solely because the loan is made to or the investment is in commercial, residential, or industrial property, unless such investment or loan may affect the institution's safety and soundness."

While the aim is to issue a uniform criteria for the evaluation of real estate loans (which lenders must use to make their loan decisions), the Act does provide for variation:

(b) Variations permitted. - In prescribing standards under paragraph (1), the appropriate Federal Banking agencies may differentiate among types of loans -

(i) as may be required by Federal Statute,

(ii) as may be warranted, based on the risk to the deposit insurance fund; or

(iii) as may be warranted, based on the safety and soundness of the institutions."29

The Act also addresses the issue of licensing of real estate appraisers. During the real estate boom, banks obtained appraisals from licensed and unlicensed appraisers. Many states did not have a formal licensing program for appraisers. Real estate appraisers earned their credentials from private organizations. Congress specifically amended the Financial Institutions Reform, Recovery and Enforcement Act of 198930 prohibiting the Appraisal Subcommittee from setting qualifications or experience requirements for the states. Any recommendations that the Appraisal Subcommittee develops are non-binding on the states.

While Congress has empowered and directed all federal regulatory agencies to develop a uniform criteria for real estate loan analysis, they have resisted the temptation to "federalize" the real estate appraisal profession. However, it is clear that the Appraisal Subcommittee's recommendations may ultimately find their way into state laws licensing real estate appraisers.

Foreign Bank Regulations

Section 202 which amends the International Banking Act of 1978 contains new regulations applying to foreign held banks.31  Section 202 of the FDIC Improvement

29 2 Cong. News 91 Bd. Vol., 105 STAT 2354, Federal Deposit Insurance Corporation Improvement Act, Section 304(a) (B). This is actually an amendment to 12 USC 1828, the Federal Deposit Insurance Act.
30 12 USC 3345.
31 12 USC 3105.
Act is designed to "...strengthen the Federal supervision and regulation of foreign banks in the United States." 32 The Act requires prior approval by the Federal Reserve Board before any foreign bank can buy or set up a banking office in the United States. 33 Section 202(d) gives the Board the authority to turn down any acquisition of a bank by a foreign bank or holding company unless banks provide full financial disclosure. 34 Many Japanese banks do not disclose the nature of their assets (loans) or the extent of their collateral. Unless their practices change, this provision should create a regulatory roadblock to more acquisitions of U.S. banks by foreign banks.

Under the new standards, foreign banks seeking to merge with a U.S. bank must submit an application with all required information. The required information includes financial and managerial resources of the foreign bank (including their ability to operate as an international bank) and whether the foreign bank has provided the Board with adequate assurances that the bank will make available to the Board all information needed to comply with all U.S. federal banking laws. 35

The Act gives the Federal Reserve Board authority to terminate banks that fail to comply with federal banking regulations. 36 For the first time, foreign banks operating in the U.S. will fall under the same Federal Reserve Board reporting requirements as U.S. banks 37 and will therefore be subject to the new Federal Risk-Based Capital requirements. The Act also gives the Board the authority to coordinate bank examinations conducted by the FDIC, the Comptroller of the Currency and the Federal Reserve. 38 Foreign banks will be subject to the other provisions of the FDIC Improvement Act and may be terminated for "unsafe or unsound banking practices." 39 The Act also empowers all federal agencies that regulate banks to disclose any information gained in their supervisory role to foreign bank regulators. 40 If federal

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33 2 Cong. News 91 Bd. Vol., 105 STAT 2287, Federal Deposit Insurance Corporation Improvement Act, Section 202 (d).
37 2 Cong. News 91 Bd. Vol., 105 STAT 2287, Federal Deposit Insurance Corporation Improvement Act, Section 202 (a).
38 2 Cong. News 91 Bd. Vol., 105 STAT 2291, Federal Deposit Insurance Corporation Improvement Act, Section 203 (a)
authorities terminate a foreign owned bank or levy civil penalties against foreign banks, federal agencies including The Federal Reserve Board, Comptroller of the Currency, Federal Deposit Insurance Corporation and Director of the Office of Thrift Supervision may disclose information obtained in the course of exercising supervisory or examination authority to any foreign bank regulatory agency. Section 205 of the Act requires foreign banks to comply with the same reporting requirements as domestic banks in reporting loans secured by 25% or more shares of insured depository institutions.

One other significant change is that the U.S. will no longer insure foreign deposits in U.S. banks. The Act ends the role of the Federal Deposit Insurance Corporation or any other banking agency that is controlled by the United States government from insuring foreign deposits in U.S. banks.41

The Federal Deposit Insurance Corporation Improvement Act of 1991 makes major changes in the game rules for foreign banking institutions. The result of the new rules mean that foreign banks will be competing under the same reporting and operational rules as American banks. In summary, the significant changes for foreign banks include: (1) granting the Federal Reserve Bank the power to approve any operations in the U.S., (2) the requirement that foreign banks intending to merge or acquire any U.S. bank provides U.S. regulators with the same information U.S. banks provide, (3) the requirement that foreign banks must comply with all federal banking requirements, and (4) that agencies of the federal government will not insure foreign deposits in U.S. banks.

**Brokered Accounts**

The Act places strict limitations on financial institutions to accept brokered accounts. Only institutions that fall into the well capitalized" asset category will be permitted to accept brokered accounts. To prevent banks from expanding their ability to make loans by "purchasing" deposits with usually high interest rates, the act provides that banks:

may not pay a rate of interest on such funds which, at the time that such funds are accepted, significantly exceeds-

(1) the rate paid on deposits of similar maturity in such institution's normal market area for deposits accepted in the institution's normal market area; or

41 2 Cong. News 91 Bd. Vol., 105 STAT 2367, Federal Deposit Insurance Corporation Improvement Act, Section 312.
(2) the national rate paid on deposits of comparable maturity, as established by the Corporation, for deposits accepted outside the institution's normal market area...\textsuperscript{42}

Congress's intent was to avoid the situation where banks in jeopardy of violating capital rules were obtaining brokered deposits. Many "troubled" institutions obtained temporary relief from federal intervention by expand their capacity to make new loans. Many troubled banks hoped that the additional capital would generate profits from loans that would ease their capital crisis (by increasing retained earnings). More often than not, the banks sank into deeper problems because the spread between what they were paying to depositors and the interest charged on new loans was not adequate. And, banks made these newer loans just at the peak of the real estate boom. These new loans were the first loans to fall into the non performing category. Many institutions used brokered accounts to increase their earnings by making more real estate loans to increasingly risky developers. The result was a leveraging of an already overexpanded real estate market. When the real estate market weakened due to a soft economy and an oversupply of commercial and residential stock, developers walked away from their loans. Banks foreclosed but they were unable to sell the properties for enough to cover the unpaid balance of the loan. Once loan reserves were used up the banks no longer had capital resources to meet FDIC or Federal Reserve Board capital requirements, the FDIC took over failed institutions. The FDIC paid off hundreds of millions of dollars of insured deposits.

**Risk Based Capital Insurance Premiums**

To fund the massive payouts that FDIC has been making, the Act sets up a new method of assessing banks for insurance. This new method reflects the philosophy embodied by the Risk-Based Capital Requirements. The scheme is that the FDIC should charge different insurance premiums for each risk category of capital. The more a bank has a portfolio of loans in the high risk categories, the higher the rate that bank would have to pay for its premium.\textsuperscript{43} The Act ends the practice of charging an insurance premium on a bank's total capital.

In accordance with the Act, the FDIC Board of Directors issued a rule describing the risk-based premium system. Under the rule which goes into effect January 1, 1992, a

\textsuperscript{42} 2 Cong. News 91 Bd. Vol., 105 STAT 2344, Federal Deposit Insurance Corporation Improvement Act, Section 301.

\textsuperscript{43} 2 Cong. News 91 Bd. Vol., 105 STAT 2345, Federal Deposit Insurance Corporation Improvement Act, Section 302.
bank or thrift will pay within a range of 23 cents per $100 of domestic deposits (the current rate for all institutions) to 31 cents per $100 of domestic deposits depending on its risk classification. The FDIC projects that about 75 percent of the 12,000 insured commercial banks and savings banks (with 51 percent of the deposit base) and 60 percent of the 2,300 insured thrifts (with approximately 43 percent of the deposit base) will be in the lowest-rate paying group. Only about 220 banks (two percent of all insured commercial and savings banks) and 160 thrifts (seven percent of all insured thrifts) are expected to be in the group paying the highest insurance rate. The FDIC estimates that banks will pay an average rate of about 25.4 cents per $100, compared to 25.9 cents per $100 for thrifts.

The FDIC Board will meet again in 1992 to determine whether changes in their premium rates are necessary. Their intent is to review the rate schedule every six months.

The FDIC will be placing each institution into one of nine categories. As shown in the table below, each institution will be assigned to one of three groups based on its capital ratios. The three categories are well capitalized, adequately capitalized and undercapitalized. A well capitalized institution must have at least 10 percent "total risk-based capital ratio (the ratio of Tier 1 or "core" capital to risk-weighed assets and a five percent "Tier-1 leverage capital" ratio (the ratio of Tier 1 capital to total assets). An adequately capitalized institution will have at least an eight percent total risk-based capital ratio, a four percent Tier-1 risk-based capital ratio and a four percent Tier-1 leverage capital ratio. Undercapitalized institutions do not meet any of the above qualifications.

The FDIC will further classify institutions according to their own "subjective" rating of the institutions financial integrity. Group "A" is for institutions that are financially sound or having only a few minor weaknesses. Group "B" is for institutions with weaknesses which, if not corrected, could result in significant deterioration of the institution and increased risk to the insurance fund. Group "C" is for institutions that pose a substantial probability of loss to the insurance fund unless effective corrective action is taken. This classification scheme requires the FDIC to consider asset quality, loan underwriting standards and other operating systems.44

In adopting the following premium grid, the FDIC noted that the spread between the highest premium and the lowest premium is eight points. Their initial proposal called for a six point spread. In settling on the eight point spread, the Board commented: "While this spread does not adequately reflect the difference in risk to the FDIC between the

44 Watson, William R., Director, Federal Deposit Insurance Corporation, "Letter to Chief Executive Officer" of October 7, 1992 FIL-71-92
weakest and strongest institutions, the Board is concerned that a larger spread could create sufficient disruption and hardship to weak institutions as to be inconsistent with the spirit of the transition rule. A wider spread may be recommended with the permanent risk-based assessment system."  

Under federal law, the FDIC Board of Directors must set semiannual assessment rates sufficient to increase the reserve ratio to 1.25 percent within a fifteen year period. The BIF's actual reserve ratio as of July 1992 was negative by $5.5 billion dollars or negative by .28 percent. The Board concluded that it would be impossible to set an assessment rate high enough to bring the ratio up to 1.25 percent within a year, so they issued a "BIF Recapitalization schedule. The schedule based on the proposed assessment rate of 28 basis points as of January 1, 1993 shows a positive reserve ratio beginning in the year 2006.

<table>
<thead>
<tr>
<th>Premium Grid</th>
<th>Table 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital level Rank:</td>
<td>Well Capitalized</td>
</tr>
<tr>
<td>Supervisory Rank</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>23</td>
</tr>
<tr>
<td>B</td>
<td>26</td>
</tr>
<tr>
<td>C</td>
<td>29</td>
</tr>
</tbody>
</table>

Massive New Regulations Forthcoming

The Federal Deposit Insurance Improvement Act of 1991 sets forth the general guidelines for future regulations. Federal agencies will devise rules consistent with the legislative mandates. Many of the future rules will constrain banking practices that Congress found aggravated the banking crisis. Table 2 describes the subject matter of future regulations.

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45 Federal Register, Vol 57 No. 191 of Thursday, October 1, 1992 p. 45265.
46 12 USC 1817, Section (b)(1)(B) of the FDI Act
47 Federal Register, Vol 57 No. 191 of Thursday, October 1, 1992 p. 45265.
Schedule for New Regulations

Table 2

<table>
<thead>
<tr>
<th>Area of Regulation</th>
<th>Statute Section</th>
<th>Agency</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auditing Standards</td>
<td>112</td>
<td>Appropriate Federal Banking</td>
<td>none</td>
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<td></td>
<td></td>
<td>Regulatory Agency</td>
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<tr>
<td>Standards for Safety &amp;</td>
<td>132</td>
<td>Federal Banking Agency</td>
<td>8/1/93</td>
</tr>
<tr>
<td>Soundness</td>
<td></td>
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<tr>
<td>Brokered Deposits</td>
<td>301</td>
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<tr>
<td>Risk Based Assessment Rules</td>
<td>302</td>
<td>FDIC</td>
<td>7/1/93(a)</td>
</tr>
<tr>
<td>Real Estate Lending Standards</td>
<td>304</td>
<td>Federal Banking Agency</td>
<td>3/19/93</td>
</tr>
<tr>
<td>Risk Based Capital Standards</td>
<td>305</td>
<td>Federal Banking Agencies</td>
<td>6/19/93</td>
</tr>
</tbody>
</table>

(a) See Premium grid shown in Table 1

Conclusion

In signing the bill, President Bush lamented Congress's failure to de-regulate the banking industry through the repeal of the Glass Speagal Act:

This legislation fall far short of the truly comprehensive reform proposal that my Administration sent to the Congress early this year. Our proposal squarely addressed the fundamental problems of the banking industry - the need to re capitalize the Bank Insurance Fund; the need to make banks safer, stronger and more competitive; the need to attract private capital into the industry; and the need to protect the taxpayer from a costly deposit insurance bailout. ... While it includes some of regulatory reforms we proposed last February, it does nothing to restore the competitiveness of the banking industry. ... This shortsighted congressional response to the problems we face increases taxpayer exposure to bank losses. The Congress must shoulder its responsibility for not adopting proposals to make banks stronger and more competitive. The Congress must also assume responsibility for exacerbating the "credit crunch" that has restrained banks from lending to even their best customers....49

The 158 page-long Federal Deposit Insurance Corporation Improvement Act of 1991 prescribes complex risk-based capital category regulatory framework. The FDIC has

issued several important rules in accordance with the law that are consistent with the risk-based regulatory philosophy. While the regulations will not change end economic cycles or the changes in economic behavior brought about by changes in tax laws, bankers and industry observers need to understand that the basic regulatory framework is entering a new era. Bank regulators have powerful new regulatory weapons to use to restrict the behavior of banks in financial difficulty. The Act and its related regulations will impose new reporting requirements and give a new life to the regulatory role of the Federal Deposit Insurance Corporation (as opposed to the Federal Reserve Board). Some commentators predict an increase in bank consolidations due to the added regulatory burden. In addition to the internal expenses of setting up procedures to comply with the new regulations, the Act permits the FDIC to charge for its examinations and mandates that on-site examinations every 12 months.

The new capital standards and forthcoming real estate lending standards may well reduce the amount of funds for commercial and real estate loans. We speculate that banks will be inclined to hold more of their loan portfolios in the form of federal securities and will securitize real estate loans to maximize return on equity. Whether the Act will be successful in preventing a repeat of conditions that some say Congress created remains to be seen.

The scope of this Act is very broad and not narrow as some have described it. The minimum ratio for market-to-book value for publicly traded bank stocks and other tripwire standards will bring federal regulators into an institution before it falls into the "troubled" categories. The Act subjects bank officers to a web of federal regulations on what was previously strictly internal decisions. Bank officers and directors must observe new regulations on executive compensation. The traditional banker with a heavy financial background may well need a staff of compliance officers to insure that the bank does not unintentionally fail to maintain the proper documentation and policies that would invite federal oversight.

What the Securities Exchange Act of 1934 was to the securities industry is what the FDIC Act will be to the banking industry. Financial executives, students and banking officials will be reviewing the aftermath of this legislation and its related rules for years to come.