Why GAO Did This Study

More than 300 insured depository institutions have failed since the current financial crisis began in 2007, at an estimated cost of almost $60 billion to the deposit insurance fund (DIF), which covers losses to insured depositors. Since 1991, Congress has required federal banking regulators to take prompt corrective action (PCA) to identify and promptly address capital deficiencies at institutions to minimize losses to the DIF. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires GAO to study federal regulators’ use of PCA. This report examines (1) the outcomes of regulators’ use of PCA on the DIF; (2) the extent to which regulatory actions, PCA thresholds, and other financial indicators help regulators address likely bank trouble or failure; and (3) options available to make PCA a more effective tool. GAO analyzed agency and financial data to describe PCA and DIF trends and assess the timeliness of regulator actions and financial indicators. GAO also reviewed relevant literature and surveyed expert stakeholders from research, industry, and regulatory sectors on options to improve PCA.

What GAO Found

Although the PCA framework has provided a mechanism to address financial deterioration in banks, GAO’s analysis suggests it did not prevent widespread losses to the DIF—a key goal of PCA. Since 2008, the financial condition of banks has declined rapidly and use of PCA has grown tenfold. However, every bank that underwent PCA because of capital deficiencies and failed in this period produced a loss to the DIF. Moreover, these losses were comparable as a percentage of assets to the losses of failed banks that did not undergo PCA. While regulators and others acknowledged PCA’s limitations, regulators said that the PCA framework provides benefits, such as facilitating orderly closures and encouraging banks to increase capital levels.

PCA’s triggers limit its ability to promptly address bank problems, and although regulators had discretion to address problems sooner, they did not consistently do so. Since the 1990s, GAO and others have noted that the effectiveness of PCA, as currently constructed, is limited because of its reliance on capital, which can lag behind other indicators of bank health. That is, problems with the bank’s assets, earnings, or management typically manifest before these problems affect bank capital. Once a bank falls below PCA’s capital standards, a bank may not be able to recover regardless of the regulatory action imposed. GAO tested other financial indicators, including measures of asset quality and liquidity, and found that they were important predictors of future bank failure. These indicators also better identified those institutions that failed and did not undergo the PCA process during the recent crisis. Although regulators identified problematic conditions among banks well before failure, the presence and timeliness of enforcement actions were inconsistent. For example, among the banks that failed, more than 80 percent were on a regulatory watch list for more than a year, on average, before bank failure. However, GAO’s analysis of regulatory data and material loss reviews showed that actions to address early signs of deterioration were inconsistent and, in many cases, regulators either took no enforcement action or acted in the final days before an institution was subject to PCA or failed. Without an additional early warning trigger, the regulators risk acting too late, thereby limiting their ability to minimize losses to the DIF.

Most stakeholders (23 of 29) GAO surveyed agreed that PCA should be modified and identified three top options to make it more effective. The first option—incorporating an institution’s risk profile into PCA capital categories—would add a measure of risk to the capital category thresholds beyond the existing risk-weighted asset component. The second option was increasing the capital ratios that place banks in PCA capital categories. The third most popular option was including another trigger for PCA, such as asset quality or asset concentration. Each option has advantages and disadvantages. For example, while an additional trigger could account for other factors often found to precede capital deterioration, it might be difficult to implement. Although stakeholders supported these broad options, they cautioned that the manner in which any option was crafted would determine its success.

What GAO Recommends

GAO recommends that the bank regulators consider additional triggers that would require early and forceful regulatory action to address unsafe banking practices as well as the other options identified in the report to improve PCA. The regulators generally agreed with the recommendation.