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Prompt Corrective Action Provisions: Are Insurance Companies and Investment Banks Next?

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In 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA). The Act aimed to recapitalize once and for all the depository insurance schemes for banks and savings and loan institutions. It also provided for risk-based deposit insurance premiums, put explicit limits on the application of a "too big to fail" principle for banks and required that examiners implement "prompt corrective action" (PCA) standards for banks. Essentially these steps were to improve the functioning of the FDIC, especially removing discretion of the examiners in the process of addressing the risk of failure of banks and providing explicit requirements of managing the deteriorating risk of failure and providing for rising insurance premiums for such banks. In particular, PCA established a set of capital benchmarks and required regulator actions that removed privileges for banks to manage their capital and payments of income to shareholders and bank creditors as the capital position of the bank deteriorated and the risk of failure rose. In effect, regulators could take preemptive action to keep banks from depleting their capital as their capital positions deteriorate.

These provisions have drawn increasing public attention in the past year for very different reasons. First, Senate Bill 40, The National Insurance Act (NIA), which provides new opportunities for insurance companies to obtain their charters and to be regulated by a federal government entity instead of only the state governments, also requires that the new federal regulator develop and apply prompt corrective action provisions to the supervision of federally chartered insurance companies. The NIA allows insurance companies to have an "optional federal charter" (OFC), so that they may

choose their regulator, keeping their charter and regulatory control by state government institution(s) or choosing the federal regulator. In that sense, insurance would join banks, thrift institutions, and credit unions in having access to a dual chartering regime in which they could choose the level of government at which they wish to be regulated. Perhaps not surprisingly, the NIA explicitly requires that the new federal regulator apply PCA to the insurance companies they regulate, just as federal bank regulators must apply PCA to banks.

The second reason that these provisions have drawn attention recently is the near failure and sale of Bear Stearns. The Federal Reserve helped arrange the sale of Bear Stearns in March 2008, with the sale to be completed shortly, to preempt its failure and consequent effects on other financial institutions. At about the same time, the U.S. Department of Treasury released its long awaited "Blueprint for a Modernized Federal Financial Regulatory Structure" that calls for the Board of Governors of the Federal Reserve System to have broad regulatory power over all financial institutions on issues related to financial market stability. These actions call attention to the absence of regulatory oversight powers by the Fed, in particular, enabling legislation that would allow the Fed to close investment banks or other failed or failing institutions in the same way that they can or must close such banks.

The near failure and subsequent nationalization of Northern Rock, a mid-sized bank in England, raised similar concerns as British regulators do not have the same closure abilities or mandates as exist in the United States, nor do they have PCA provisions that could have preempted the failure of Northern Rock.

What is Prompt Corrective Action?

Prompt corrective action (PCA) is a system of regulatory steps that can or must be taken if a bank's capital falls short of certain prescribed benchmarks. The aim is to increase pressure on a bank to take actions to insure that it will not fail because its capital gets too low to avoid bankruptcy. PCA introduced a reliance on the Tier 1 leverage ratio, the ratio of Tier 1 capital to total assets, in classifying banks. Ignoring risk-based capital requirements, the banks are classified as:

- "well capitalized," if its ratio exceeds 5 percent,
- "adequately capitalized" if its ratio is 4 percent to 5 percent,
- "undercapitalized" if its leverage ratio is 3 percent to 4 percent,
- "significantly undercapitalized if its leverage ratio is 2 to 3 percent, and
- "critically undercapitalized" if its leverage ratio is below 2 percent.

Tier 1 capital includes common stockholder equity, non-cumulative perpetual preferred stock and minority

interests in the equity accounts of consolidated subsidiaries. The leverage ratio criteria and PCA requirements supplement the risk-based capital requirements introduced by the Basel accords in 1988. Table 1 provides the broader classification framework for PCA. See Spong (2000) or Benston and Kaufman (1997) for more detailed discussions of capital requirements and prompt corrective action.

As a bank's leverage ratio falls from well capitalized to lower levels, regulators impose restrictions on distributions of funds that can be used to boost capital and they can or must require more substantial actions. For example, under PCA, issuing brokered deposits or underwriting securities are viewed as privileges that are removed if a bank falls to the adequately capitalized level. If the capital ratio falls to the undercapitalized zone, the bank must develop and submit a capital restoration plan to regulators, it must restrict asset growth and it must secure regulatory approval before opening new branches or new lines of business. When the leverage ratio falls further to the "severely undercapitalized" level, the bank cannot pay interest above its peer group average as determined by the regulator, and finally, when the leverage ratio falls below 2 percent, steps must be taken to close the bank. Clearly, an effort is made to insure that banks do not close with any liability for the FDIC to cover insured deposits, though failures usually come quickly at the end and it is hard to keep a bank with a 2 percent ratio from deteriorating to negative equity in a very short period of time before it can be closed.

Prompt corrective action's reliance on the leverage ratio is a departure from the risk-based capital standards adopted under Basel I, the international agreement on capital standards established in 1988 or updated in Basel II. Those capital standards attempt to attune the required capital held by banks to the risk of assets. They require the use, at least by large banks, of an internal ratings-based approach to assessing credit risk. Reliance on a leverage ratio is regarded as crude by proponents of the Basel accords because the interpretation of a given leverage ratio is not adjusted for the risk of the total assets of the bank. Thus a 5 percent ratio of capital to assets is huge if the assets are very safe government securities and is mush smaller relative to risk if all of a bank's assets are commercial and industrial loans. The major advantage of PCA is that the leverage ratio it introduced as a capital standard is simple and transparent to investors, customers and regulators alike, but it also has the advantage that it implies a generally higher level of capital than Basel I or Basel II risk-based capital requirements. Vaughan (2008) notes that Basel I was introduced at about the same time (implemented by the end of 1992) as prompt corrective action so that improved capital positions of banks may not have been due to PCA. Gilbert (2006) has shown that most banks, es-

pecially large ones, are more constrained by the leverage ratio than they are by risk-based measures, so that being well-capitalized usually requires a higher level of capital than risk-based measures alone.

Risk-Based Capital Requirements

Because of concerns over bank failure and differences in capital standards across the developed world, developed country central banks created the Basel Committee on Capital Standards in the 1980s. This group developed the Basel I standards, grew into the Financial Stability Forum and developed Basel II standards. Because of the capital losses credit crisis and financial sector failures in 2007-08, there is talk of a Basel III. The central idea of the Basel accords is to standardize capital requirements and to recognize the risk sensitivity of the appropriate amount of capital. Basel requires two sets of requirements for Tier 1 capital and total capital, with both measured relative to risk-weighted assets. The concept of risk-weighted assets is a measure of bank assets that accounts for the fact that some bank assets are very risky and that others are not. Thus standard assets such as commercial and industrial loans are the riskiest and have a weight of 100 percent, but other assets, such as loans to governments or their agencies or marketable government securities, are less risky in terms of the risks of default (credit risk) or market price fluctuations (market risk) so that these assets have less weight in measuring risky assets. The biggest problem with Basel I was that there were few risk categories for differently weighted assets and also banks found it easy to arbitrage the capital requirements by moving risky assets off the books or disguising them as safer assets while loading up on the safer assets on their balance sheets. Banks were also able to use guarantees, collateral, netting arrangements and credit derivatives to alter the risk assessment of risky assets. Thus banks were able to game the system.

Basel II attempted to provide more pillars for adequate capital standards. It is based on the recognition that large international banks and some others had developed very good international rating systems that allowed them to have much better measurements and assessments of risk, as well as more sophisticated systems for controlling risk. The banks own "internal ratings system" were judged to be more likely to reflect the appropriate risk weights for various bank assets and Basel II provided for banks to be able to use these weights instead of externally generated and imposed weights, though smaller banks were able to develop risk weighted asset measures based on such external measures. To protect against internal abuse, Basel II provided two other pillars to serve as checks on bank measures. The second pillar is regulatory bank supervision which will review internal methods and provide assessments of the internal methods, and the third pillar is market disci-

pline, the external assessment of the bank's risk by the marketplace, especially in pricing the bank's stock and its marketable debt. Basel II is just beginning to go into use in Europe and will do so in the United States in 2009. Thus it is too early to assess how the new standards will work. The most important point is that Congress and regulators are unlikely to allow U.S. capital requirements to fall dramatically as a result of Basel II implementation, no matter how low risk-weighted assets are relative to total assets.

The chart, taken from the *Economist* magazine of May 15, 2008 and based on Citigroup data, shows that European banks' risk-based capital ratio have bordered on being adequately capitalized under the U.S. standard for risk-based Tier 1 capital from 2001-03.

Chart
European banks are poorly capitalized by U.S. PCA standards

Source: "Cycle clips," Economist Magazine, May 15, 2008

However, the leverage ratio shows that the average bank has been undercapitalized since 2000 and the status has been deteriorating throughout the period. In 2007 the ratio indicated that the average bank was significantly undercapitalized using the U.S. leverage ratio classification system for PCA.

Table 1 shows how both standards are used in the United States to define how well capitalized a bank is; thus the average European bank would be classified as undercapitalized from 2000 to 2006 and significantly so in 2007, but this is not the case under risk-based measures. Kaufman (2006) and Kane (2006) argue that PCA's leverage ratio provides a more effective and simpler way to set prudential safety standards than Basel II or risk based measures generally. Vaughan (2008), however, suggests that risk-based capital requirements, at least as drawn up in model legislation used by the National Association of Insurance Commissioners, provide an adequate substitute for prompt corrective action provisions. The latter are called for in the National Insurance Act. Risk-based capital measures in banking and insurance were developed to provide a higher prudential standard of capital management to avoid failure. But Basel requirements, in the absence of PCA, do not impose mandatory restrictions on regulators and, in the case of insurance, it is optional for state regulators to adopt and also optional for the provisions to be implemented. More importantly, it is a guideline for classifi-

cation with no direct teeth for enforcement or motivation. In the case of insurance, required reporting is annual, while it is quarterly for banks. Since capital can be depleted quickly at the end of the life of a failing institution, more frequent monitoring is vital. As Vaughan (2008, p.8) notes, what she refers to as insurance PCA "is less specific about the nature of regulatory action that must be taken and does not contain specific limitations on insurer activities at different capital levels."

Most important, banks find value in being "well capitalized"; PCA requirements for this classification are more difficult and costly to achieve and usually force institutions to maintain a higher overall capital cushion than do the risk-based requirements [see Gilbert (2006)]. In turn this has meant that U.S. banks have been more immune to failure since the adoption of PCA.

Well capitalized banks benefit by having higher stock market valuations for given earnings, a lower cost of capital and a higher capital cushion when there are credit losses and earnings shocks, as they have had since mid-2007. While increased bank failures are expected

Table 1
Criteria for Classifying Banks as Adequately and Well Capitalized

	Risk-based capital ratios			PCA measure	
Capital Classification	**Total capital as a percentage of risk-weighted assets**		**Tier 1 capital as a percentage of risk-weighted assets**		**Leverage ratio (Tier 1 capital/ total assets)**
Well capitalized	**10 percent or greater**	**AND**	**6 percent or greater**	**AND**	**5 percent or greater**
Adequately capitalized	**8 percent or greater**	**AND**	**4 percent or greater**	**AND**	**4 percent or greater**
Undercapitalized	**Less than 8 percent**	**OR**	**Less than 4 percent**	**OR**	**3 percent to 4 percent**
Significantly undercapitalized	**Less than 6 percent**	**OR**	**Less than 3 percent**	**OR**	**Less than 3 percent**
Critically undercapitalized	**NA**		**NA**		**Less than 2 percent***

***Ratio of tangible capital to total assets.**

Source: Gilbert (2006) and Spong (2000).

A well *capitalized* bank must also be free of any directive from its supervisor to maintain a specific capital level.

from recent credit market events, the numbers are expected to be smaller because of higher capital ratios going into the crisis. Most banks today are well capitalized and hold higher capital than they would without PCA standards. These higher ratios are also making raising new capital easier and less costly.

Prospects for Other Financial Institutions

Setting federal standards for capital requirements at investment banks and insurance companies is on the horizon. Fed interest in the stability of investment banks and perhaps even hedge funds is a likely result of expanded federal regulatory powers of the Fed and their perceived interest in the financial viability of these firms. Similarly federal regulatory provision of prompt corrective action standards for nationally chartered insurance companies is likely if the National Insurance Act creates a federal role in chartering and regulation of insurance companies. Not only will both efforts require new capital requirement standards, but some coordination with existing or new schemes for insurance of firms' liabilities will be necessary. In addition new statutes or rules for closure, merger or liquidation will be necessary to minimize the exposure of insurance funds, whether federal or not, to failure of these institutions.

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Social Security: The Retirement Dilemma

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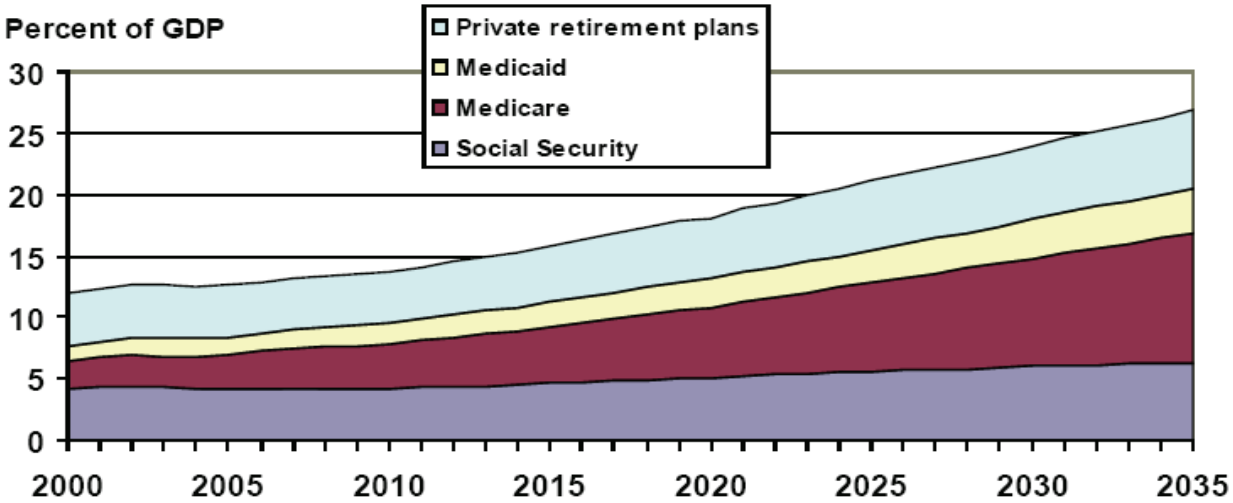
Outlook

The Social Security Administration (SSA) estimates that more than 90 percent of individuals over the age of 65 receive social security benefits. Two-thirds of these receive most of their income from social security and over 20 percent have it as their only source of income. [1] The 2008 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Federal Disability Insurance Funds (OASDI) [2] further estimates that its tax revenue will cover the current level of scheduled benefits until 2017, after which it shall have to start redeeming trust fund assets. Redeeming these assets will enable full payment of benefits till 2041. Unless changes are made by that time, the OASDI report reveals that the SSA will, at present tax rates, be able to pay only up to 78 percent of scheduled benefits through to 2082, and 75 percent thereafter. These estimates are due to the large number of retirees from the baby boom generation, the first of whom are eligible for early retirement benefits from 2008. Longer life expectancy rates necessitated changes in the law on the retirement age in 1983 upon recommendations by the National Commission on Social Security Reform. Full retirement age is 65 for those born before 1938. If born between 1938 and 1960, this retirement age gradually rises; retirement for those born after 1960 is set at 67. Subsequent increases in longevity and the generosity of benefits, especially for Medicare, have worsened the outlook substantially.

Unless changes are made soon to address the social security crisis, then the standard of living for large segments of the population could decline drastically. Whereas the estimated number of workers per beneficiary was 3.3 in 2007, OASDI projects this to come down to 2.2 by 2030, when almost all baby boomers will have retired. With lower expected mortality rates, this will put an additional strain on the workforce, members of which will potentially have to give up more of their income to service these payments, at least if promised future benefits remain the same. Schieber (2008) estimates that for a worker to retire at 65 in 2005, it costs about 30 percent

of payroll per worker. This figure would jump to about 52 percent of average pay per worker retiring at the same age in 2030. He expects retiree consumption (including claims on the economy from Medicare, Medicaid, Social Security and private retirement plans) to more than double from 13.2 percent of GDP this year to 26.8 percent by 2035. The productive workforce will therefore have to bear the burden to sustain this amount, as well as to meet their own consumption. Figure 1 shows the total retirement income claims on the economy to 2035. Saving (2007) reinforces this belief, saying that by 2030, "more than one half of all federal income tax revenues will be consumed by Social Security and Medicare." When healthcare financing is factored in, the numbers get grimmer. With healthcare costs projected to rise at a faster rate than the cost of social security, the effect shall be to continually reduce the disposable income of retirees (See Table 1). Saving (2006) also makes projections on the payroll tax rate required to fund the Medicare deficit. By 2020, the Medicare payroll tax rate will more than double to 6.23 percent from the current 2.9 percent. By 2030, this rate will have more than tripled to 9.66 percent and will be four times as high in 2040, at 12.66 percent. By the end of the Trustees 75-year projection period, this number will be seven times as high as the current rate, at 19.9 percent. These levels raise the question of whether planners are currently underestimating how much we should be saving towards retirement to maintain an acceptable standard of living.

Figure 1: Total Retirement Income Claims on the Economy[1]



Proposals

To begin addressing some of these issues, various proposals have been suggested. The American Academy of Actuaries in its 2007 "Public Policy Monograph on Social Security Reform Options" categorizes the solu-

tions in two broad categories, tax changes and benefits changes.

Tax changes could take the shape of either increasing the payroll tax, increasing the limit on taxable earnings, increase the taxation of benefits and last, but not least, possibly expanding coverage to non-covered groups such as those in state, local government or employees working for religious organizations.

Benefits changes could consider reducing benefits across the board, raising the normal retirement age, changing the benefits formula by altering the PIA (primary insurance amount) percentages, changing the initial benefit formula by increasing the averaging period of earnings from 35 to, say, 38 years, thereby reducing the benefits for those with a shorter work history. Other proposals include changing the auxiliary benefits to family members or reducing the cost of living adjustments (COLA), which most economists think is being overestimated by the use of the consumer price index. One proposal to reduce benefits by Chairman Edward Gramlich in the 1994-1996 Advisory Council's Report on Social Security, is to provide a "double–deck" benefit format that would provide a flat dollar amount for all workers with a specified minimum number of years of earnings, regardless of the amount of earnings, and thereafter receive a specified percentage of average earnings.

One of the solutions being floated involves having people work longer by raising the earliest eligibility age, currently at 62, together with other reforms. Munnell (2008) calculates that 59 percent of women and 54 percent of men retire at this age. The effect of doing this would be to reduce the retirement period and, by extension, the amount of resources required. The tax burden

Table 1: Projected payroll cost per worker[ii]

		Workers' costs (as a percentage of pay) associated with:				
Date of Retirement	**Age at Retirement**	**Own Retirement Saving**	**Own Health Insurance**	**OASDI Benefits**	**Medicare & Medicaid**	**Total**
1960	65	4.3	1.2	5	0	10.5
2005	65	4.9	9.1	12.4	4.9	31.3
2005	62	7	9.1	12.4	4.9	33.4
2005	58	10.2	9.1	12.4	4.9	36.6
2005	55	13	9.1	12.4	4.9	59.4
2030	65	5.7	17.9	15	13.8	52.4
2030	62	7.7	17.9	15	13.8	54.4
2030	58	10.9	17.9	15	13.8	57.6
2030	55	13.8	17.9	15	13.8	60.5

to support this population would also be reduced. However, Munnell adds that this option would probably require an expansion of the disability program as well. Also, raising this age would reduce lifetime social security benefits for demographic groups with lower life expectancies such as African-Americans and low-wage workers. The American Academy of Actuaries says this would have little impact because early-retirement benefits are already reduced to actuarial equivalent payments.

While there are even more proposed solutions to this crisis, there is an increased urgency to come up with solutions, considering that there shall be more pressure exerted on the workforce the longer this drags out.

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