



**BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM**
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 94-29 (FIS)

April 29, 1994

**TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK**

**SUBJECT: Procedures to Reclassify State Member Banks Under
Authority Granted by Section 38 of the Federal Deposit
Insurance Act -- Prompt Corrective Action**

Purpose

The purpose of this letter is to explain the reclassification authority granted to the Board of Governors under Section 38 of the Federal Deposit Insurance Act, as amended (the "FDI Act") (12 U.S.C. 1831o), as added by the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), and to set forth the Board's policies and procedures for Reserve Bank recommendations to reclassify state member banks under the prompt corrective action ("PCA") provisions of Section 38 of the FDI Act.

As further described below, it is the Federal Reserve's intention to use the reclassification authority provided by Section 38 of the FDI Act in order to reflect accurately the condition of state member banks and to ensure that all appropriate actions be taken promptly to correct problems of state member banks.

Statute and Regulations

Section 38 of the FDI Act requires the Board of Governors to take certain supervisory actions promptly against state member banks falling into one of three categories of undercapitalization. The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision likewise are charged with the responsibility of implementing PCA with respect to institutions they serve as primary federal regulator.

The Board of Governors added Subpart B to Regulation H (12 C.F.R. 208.30 et seq.) in order to implement PCA. Subpart B of Regulation H establishes the tier 1 risk-based, tier 1 leverage and total risk-based capital ratio thresholds for the five PCA capital categories (i.e., well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically

undercapitalized). These ratios are calculated based on financial data available from the latest Call Report or latest examination. The Board, however, may calculate a state member bank's PCA capital ratios based on other available information, such as data obtained in the applications process, through other reports filed by the institution, or by means of public announcements by the institution. Banks that fall into one of the three undercapitalized categories automatically become subject to certain mandatory PCA actions. In addition, the Board may impose additional discretionary PCA actions through a PCA directive.

Reclassification Authority

The determination of a bank's PCA capital category is not, however, limited to the use of capital ratios alone. Under the provisions of Section 38 of the FDI Act and Section 208.33(c) of Regulation H, if a state member bank is in an unsafe or unsound condition or is deemed to be engaging in an uncorrected unsafe or unsound practice (as defined below), the Board of Governors has the authority to:

- (1) Reclassify a well capitalized bank to the adequately capitalized category;
- (2) Require an adequately capitalized state member bank to comply with one or more supervisory provisions specified by Section 38 for an undercapitalized institution; and
- (3) Impose on an undercapitalized state member bank one or more supervisory actions authorized for a significantly undercapitalized institution.

The assignment of a well capitalized bank to the adequately capitalized category and the treatment of adequately capitalized or undercapitalized banks as if they were in the next lowest capital category are each referred to as a "reclassification" for the purposes of PCA. A reclassification does not automatically subject the bank to the mandatory corrective actions applicable to institutions in the category to which the bank has been reclassified. Rather, the mandatory corrective actions, as well as any discretionary corrective actions, which may be considered appropriate, must be imposed by means of a PCA directive.

Criteria for Reclassification

An "unsafe or unsound condition" is not defined by Section 38 of the FDI Act. However, Board staff has determined that composite CAMEL ratings of 4 or 5 can effectively serve as an indicator of unsafe or unsound condition. It is presumed that institutions determined to be in an unsafe and unsound condition based on the results of the most recent report of examination will be reclassified.

Section 38 of the FDI Act also gives the Board authority to reclassify an institution for engaging in an unsafe or unsound practice. If an insured depository institution receives, in its most recent report of examination, a less than a satisfactory rating in any of the following components of the examination --- "AMEL" (assets, management, earnings or liquidity), the Board may deem the institution to be engaging in an unsafe or unsound practice if the deficiency is not corrected. Board

staff has adopted a general guideline that 3-rated CAMEL institutions for which both the assets and management components are rated 4 or 5 are engaging in an unsafe or unsound practice and should be reclassified.

State member banks with a 3, 4 or 5 rating in any AMEL component also may be reclassified for PCA purposes, but greater discretion should be exercised. In general, consideration should be given to reclassification of these banks if any of the PCA mandatory or discretionary actions would be beneficial in correcting the unsafe or unsound practice of the bank.

Procedures

Existing Conditions

At the outset, the Board's procedures will recognize that certain state member banks that currently meet the above described criteria for reclassification may have taken favorable actions that are consistent with the purposes of PCA and reclassification may not be warranted. Reclassification may not be warranted if the bank: (1) has raised, or can demonstrate current efforts to raise, enough capital to become and remain well capitalized for the foreseeable future; and (2) evidences any of the following characteristics:

- (a) The bank has endeavored to be in substantial compliance with all provisions of any outstanding informal or formal enforcement action;
- (b) Management is addressing existing problems and is considered satisfactory; or
- (c) The bank's condition is stable or shows signs of improvement.

For those remaining state member banks that currently meet the criteria for reclassification and there are no mitigating factors as described above to consider, the Reserve Bank should provide a written recommendation for reclassification to Herbert A. Biern, Deputy Associate Director, Division of Banking Supervision and Regulation. The initial recommendations should be submitted as promptly as possible, preferably within the next 60 days.

Newly Identified Candidates

For those state member banks that meet one or more of the reclassification criteria at the conclusion of their next examination there is a presumption that such banks should be reclassified. A recommendation memorandum should be prepared in conjunction with the examination report and provided to Mr. Biern within 30 days of the mailing of the examination report.

Content of Recommendation

The memorandum containing the Reserve Bank's recommendation for reclassification should identify the grounds for the recommendation and any other supporting information. A copy of the

most recent examination report, along with any other Reserve Bank reports or correspondence that support the recommendation -- particularly with regard to the identification of unsafe or unsound practices and efforts to correct them -- should be sent with the memorandum. If the Reserve Bank recommends the imposition of any of the PCA corrective actions contemplated by Section 38 of the FDI Act, a draft PCA directive may accompany the memorandum.

It should be emphasized that each state member bank that meets the above criteria should be reclassified. Reclassification should be effected regardless of whether corrective actions are recommended.

Other Related Matters

Other Statutory and Regulatory Restrictions

As you are aware, there are some statutory and regulatory restrictions that use PCA-related capital categories as the triggering mechanism. These include restrictions related to interbank liabilities and discount window availability, as well as the setting of differing amounts of federal deposit insurance premiums by the FDIC. Each of these relies on the insured bank's reported capital ratios only. Because the reclassification provisions of Section 38 do not relate to reported capital ratios, the reclassification of a bank for PCA purposes does not affect the bank's treatment under the interbank liability, discount window and FDIC premium provisions of the law.

One exception, however, is the brokered deposit regulation. If a bank is reclassified from well to adequately capitalized, it must obtain an FDIC waiver to accept brokered deposits, regardless of its actual capital level. An adequately capitalized bank treated as undercapitalized, however, is not absolutely precluded from accepting brokered deposits; it likewise may obtain a waiver.

Other Enforcement Actions

A PCA directive is one of the Board's mechanisms for addressing unsafe or unsound conditions or practices. Other mechanisms include the range of informal and formal enforcement actions. Consideration should be given as to the appropriate form of any such action at the time a recommendation regarding reclassification is made by a Reserve Bank.

If you have any questions, please call Ann Marie Kohlligian, Senior Counsel/Manager of the Enforcement Section at (202) 452-3528, or Tom Keady, Manager of the Regional and Community Supervision Section at (202) 728-5885.

signed by

Richard Spillenkothen
Director