Policy Implications of the Superior Federal Bank Failure and The New World of Financial System Risk

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Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.
900 17th Street, NW
Washington, DC 20006
info@fedfin.com
www.fedfin.com

Mr. Chairman, I appreciate the opportunity to appear this morning to discuss the lessons for policy-makers suggested not only by the Superior Federal Bank failure, but also by other recent closings of insured depositories and the new, post-attack risk context in which these specific cases must be considered. I am the managing partner of Federal Financial Analytics, a firm that has advised financial services companies in the U.S. and abroad for the last sixteen years. Federal Financial Analytics has no clients that are parties in the Superior or other recent bank failures before you today.

This hearing was just being convened on September 11 when the planes struck. It is now the first piece of regular business taken up by the Committee since the attack. It is a relief for all of us to discuss Superior FSB, a relatively ordinary failure in the ordinary times that are sadly now behind us. The lessons from the failure – and several prior ones similar to it – are, however, even more pertinent today, when hypothetical risks have now become alarmingly real.

In 1993, I was an adviser to a commission chartered by Congress to examine the causes of the S&L crisis and to make recommendations about ways to prevent another one. One major commission finding that has been cited in many other books on the 1980s crisis: Congress throughout the period was not given reliable information on which to act and, in some cases, it ignored the signs of brewing trouble. As the Commission concluded, “Congress appears to have been largely unaware of the severe problems developing in the S&L industry … By the time the extent of the problem was recognized, much of the damage was done.” The prompt attention the Superior Federal Bank case is receiving in this hearing and your interest in any action that the case may warrant indicates that one of the more important lessons of the 1980s will guide Congress in 2001.

In this statement, I would like to offer the following recommendations and conclusions, based on the Superior FSB failure, those that preceded it and the new risk profile for the financial services industry:

- The "prompt corrective action" capital standards are not a reliable guide for regulatory intervention because the capital standards on which they rest are flawed and about to become more so. Distortions in capital standards actually create incentives for banks to take risks. This was the case with Superior, because capital incentives encouraged a concentration in high-risk residual assets. It could be the case for the financial system more broadly due to proposed capital rules that will discourage banks from obtaining insurance or otherwise reducing operational risk. Congress should push for rapid action on the recourse/residual rules, and take a close, hard look at pending changes to the international risk-based capital rules.
- No bank regulator has a perfect record in recent bank failures. The FDIC should have expedited authority to review troubled institutions, but no greater authority should be granted to review healthy banks. Doing so would add regulatory burden without any offsetting improvement. Indeed, duplicative regulation could distract resources from emerging risks. Numerous improvements to supervisory practices by all of the regulators should be made.
- The pace of bank and thrift consolidation may make the OCC and OTS over-dependent on revenue from a few very large institutions. There is no evidence that this has to date resulted in forbearance, but this could occur with further consolidation. Restructuring of the assessment scheme, including consideration of use of FDIC premiums, should be considered.

Finally, in the context of a hearing examining regulatory failure, it is important also to recognize success. After the September 11 attack, the resources of our nation's financial system were strained to breaking. Treasury, the Federal Reserve and the other supervisory agencies all played an important role in acting quickly to quell any panic, right the banking ship and protect the system from further harm.

I. The Critical Importance of Correct Capital Incentives

In the wake of the banking and thrift crises of the late 1980s, Congress decided to use capital as the criterion for regulatory intervention. This made sense, since one of the other key findings of the 1993 Congressional commission cited above – along with most other analyses of the time – was that capital forbearance not only precipitated the crisis, but also significantly increased its cost.

The capital-related sanctions can be found in Section 131 of the FDIC Improvement Act of 1991. They are often called the "prompt corrective action" or PCA section, based on Congress' intent that regulators would initiate prompt corrective action when bank or thrift capital fell below designated thresholds. However, the statute does give regulators numerous options to refrain, including flexibility to delay closing a critically under-capitalized institution.

Some have argued that the PCA framework should be more prescriptive so that a primary regulator must close a bank when it fails the critical capital test. However, I am very concerned that an automatic trigger based on a single indicator of bank condition could result in the closing of some healthy banks and the ongoing operation of other, truly insolvent ones. This is because the current measures of capital adequacy on which the PCA tests are based are flawed. Indeed, under current capital standards, a bank with its entire portfolio in risk-free Treasury securities could be subject to higher regulatory capital standards than one like Superior with a portfolio of risky subprime assets.

Further, pending changes to the Basel risk-based capital standards suggest that this problem could become even worse, increasing the already wide variance between the amount of capital a bank needs as determined by the market (“economic capital”) and that demanded by bank regulators. As discussed in more detail below, the new financial risk environment makes it even more urgent that flaws in both the current and prospective capital standards be quickly remedied. Congress should oversee the capital regulatory process because failures in it could have grave macroeconomic consequences, as well as increase systemic risk.

A. The Role of Residuals and Other Structured Assets

As noted, the PCA framework is only as strong as the capital rules on which it rests. In 1991, financial markets were far simpler than at present, when financial “engineering” techniques have multiplied the ways risk can be sliced and diced among originators, issuers and investors. Failures in the capital rules accurately to reflect risk are quickly identified and exploited as banks seek to maximize their return on equity by holding assets that provide the greatest relative return (adjusted for risk) in relation to regulatory capital.

Bank regulators disagreed over the capital condition of Superior Federal Bank as it slid towards regulatory insolvency, and this is one of the disputes now before the Committee. However, the Superior case is not an isolated one. In three other recent bank failures – Keystone, Best Bank and Pacific Thrift & Loan – questions about capital adequacy comparable to those at Superior are also relevant. All four banks engaged in complex securitization transactions that put structured assets, often called residuals, on their books. The appropriate capital treatment for residuals and for other structures in which a bank retains risk, “recourse” in regulatory parlance, remains very crude in relation to the real risks posed by these complex instruments. Further, the accounting valuation of residuals remains at best an art, putting bank regulators at the mercy of accountants whose judgment proved unreliable in each of these recent bank failures.

Unsettled economic circumstances make residual valuation still more problematic. In early September, a major non-bank mortgage servicer took a $2.1 billion write-off of servicing value because of model failures, and market indications are that several other large lenders may be forced to do the same in coming weeks because of the Fed's sharp reductions in interest rates after the terrorist attacks.

Under current capital standards, the real risk of residuals and recourse positions is not captured. In some cases, risk is under-priced in capital terms, creating incentives such as those which drove Superior FSB to amass millions in complex residual interests. In other areas, risk is over-priced. For example, the current rules treat high-quality asset-backed securities the same as very risky instruments. This significantly reduces the profitability associated with lower-risk assets, creating a perverse incentive for banks to take on more – not less – risk.

Revisions to the recourse and residual capital standards have been pending for almost a decade. Regulators have been slow to act because these instruments are complex and because some institutions profit handsomely from the "risk arbitrage" opportunities created by the holes in the current capital rules. However, this failure to act has had several serious consequences. First, it created the conditions that led not only to the Superior FSB failure, but also to the others cited above. Other institutions may be suffering major revaluations in their residual books, and rapid action on the new capital rule is essential to identify these institutions and bring them into an appropriate PCA framework.

Second, the failure of the capital standards accurately to capture certain risks could now be contributing to ongoing instability in the financial markets. The September 11 attacks struck at the heart of the system for bundling loans into asset-backed securities. The bulk of this market is based on mortgage loans, but many other types of assets – e.g., credit card receivables – are similarly securitized. Private-label asset-backed securities have long labored under a capital disadvantage to those issued by government-sponsored enterprises because even the highest-rated private securities bear a far higher capital charge than securities backed by the GSEs. Rapid recovery of the securitization market would be enhanced by quick action on the recourse rules, which would remedy this capital handicap and create a quick stimulus to this troubled market. Doing so could help to reduce long-term mortgage rates because lenders would have more ready access to the secondary market, reducing their costs of doing business.

B. Additional Capital-Related Risks

Despite awesome stress, the nation's financial system recovered remarkably quickly from the destruction of the September 11 attack. This was in part the result of heroic work by the nation's financial regulators. However, it also resulted from the less noticeable years of investment by financial services firms in back-up computer centers, redundant transaction centers, contingency planning and costly insurance. None of these was cheap, and all reduced return to shareholders, but each proved essential in bringing the financial system back on line in remarkably good order in an amazingly short time.

One would assume that bank regulators would seek to build in as many incentives as possible for banks to prepare for reasonable and unreasonable disaster scenarios. However, one proposed change to the international risk-based capital rules would in fact create a perverse incentive against disaster preparedness and operational risk mitigation. This is because the proposed rules would impose a specific capital charge against "operational risk," without any discount for banks that have made the extensive investment in disaster recovery cited above.

As with the residual and recourse rules, misplaced capital incentives with regard to operational risk will encourage risk-taking, not reduce it. Rules which are very detailed and highly technical can appear to be "state of the art," but small mistakes or misplaced incentives can have significant, adverse policy consequences.

Another major problem with the rewrite of the international capital standards is its failure to deal well either with portfolio or line-of-business diversification. As a result, institutions with big portfolios of risky loans might not be penalized, nor would those which fail to engage in a prudent mix of businesses where risks tend naturally to hedge each other. This failure could in fact create a regulatory incentive for banks to become monoline institutions focusing on the high-risk end of the market. This could lead to more, not fewer, Superior-style failures.

C. Special U.S. Risks

The link between PCA and capital under U.S. law makes it especially urgent that the capital rules be properly calibrated to risk. In other countries, banks that fail the Basel or their own domestic capital rules may get a slap on the wrist, if their regulators even do that. However, FDICIA obligates U.S. regulators to take the steps outlined above if capital slips below stated thresholds. Thus, banks will maintain regulatory capital even if their true risk profile argues for far more — and sometimes far less — regulatory capital. In addition, the link between being "well-capitalized" and being allowed under the Gramm-Leach-Bliley Act to form a financial holding company ties U.S. banks far more closely to the capital standards than is the case in other countries.

The PCA framework and GLBA requirements mean that many bank examiners focus on the letter of the capital requirements, not their spirit. They impose capital sanctions in a mechanical fashion or deem banks to be well-capitalized regardless of their real risk potential. The fact that many Texas banks (e.g., First National City) were well-capitalized under the PCA framework on the day they were closed makes it clear that regulatory capital cannot be the sole criterion on which regulators base their supervisory decisions. Superior FSB's precipitous decline from the top of the capital heap to the bottom reinforces this decade-old lesson.

Policy Recommendations

In my view, the PCA framework is a valuable one, as it prevents the endless forbearance that characterized both bank and thrift regulation during the 1980s. However, the serious flaws in the current and prospective capital rules argue strongly against too tight or too mechanical a link between capital and supervisory intervention. Under PCA, there has yet to be a bank liquidation that did not cost the FDIC money, demonstrating that reliance solely on capital as the PCA trigger provide no guarantee against losses to the deposit insurance fund, as Congress intended.

Specifically, I would suggest the following:

- rapid action by bank regulators to finalize the recourse and residual rules. Congress required the bank regulators to issue the recourse rules in the Riegle-Neal Act of 1994. The Superior failure and the problems it and others expose with regard to the capital treatment of securitization-related assets makes action on these rules essential;
- Congressional review of the bank capital framework, with particular regard to the emerging Basel rules. In addition to the PCA-related problems outlined above, the rules could have a dramatic and unintended effect on economic growth and on lending to low- and moderate-income borrowers. Congress should ensure that the bank regulators are informed by broad public policy interests as the capital rules are finalized; and
- the PCA framework should be modified to reduce its reliance on capital. Banks should be upgraded in the PCA framework, as well as downgraded, when non-capital factors affect their risk profile. Further, regulators should make greater use of their power under current law to evaluate non-capital factors (e.g., management expertise) and downgrade institutions and impose sanctions accordingly.

II. FDIC Enforcement Power

The Committee is rightly concerned that bank regulators work well together, and that the FDIC be informed early about any emerging problems that might result in a cost to the deposit insurance fund. However, the FDIC already has broad authority to intervene in troubled institutions that are not dependent on cooperation from its sister agencies. For example, the FDIC can terminate deposit insurance at its sole discretion, without regard to whether a primary regulator has decided to close a bank or savings association. Further, the FDIC can under current law notify a primary regulator that it believes that PCA sanctions should be invoked. Should the primary regulator fail to do so, the FDIC can intervene. In the ten-plus years since the FDIC got these powers, they have never been used. This suggests to us that differences of opinion among the regulators are isolated and that these should be resolved through greater Congressional oversight and improved regulatory communication, not through any statutory change.

Indeed, giving the FDIC broader authority could well be problematic. There appears to be little reason to give the agency automatic authority to examine healthy banks, especially the large ones that are already subject to double and in some cases triple or more supervision from a variety of bank and non-bank regulatory bodies. Further, the FDIC has little experience with specialized, sophisticated institutions. While it might like to learn on the job to anticipate potential problems, its entry into such institutions would add considerable regulatory burden without any discernible benefit.

Indeed, supervision of all insured depositories might be improved if the FDIC worked with other bank regulators to take advantage of their expertise. While Superior and Keystone are the largest and most costly recent bank failures, the FDIC has had two smaller ones of its own. Best Bank of Colorado failed in 1999 due to very dubious management practices and questionable lending, while Pacific Thrift & Loan failed largely because of the same problems with residuals that toppled Superior. In both cases, the FDIC let as many as five years lag between the time at which it first spotted trouble and the time the banks were closed. Through these years, the FDIC appeared as reluctant to second-guess management and accountants as its sister agencies in the Keystone and Superior cases. In the era of emerging risk in which we find ourselves, it is essential that bank regulatory resources be deployed as effectively as possible, and this would argue for an FDIC focus on its own supervisory concerns, not on those under the purview of other financial supervisors. The FDIC can also make a contribution towards improving the safety of the financial system as a whole by moving rapidly on fundamental reform to the deposit insurance system to eliminate the incentives to risk-taking endemic within the premium structure of the deposit insurance funds.

Policy Recommendations

Supervising banks engaged in complex activities during trying economic times is hard work for each agency charged with doing so. When bank management is engaged in systematic fraud or desperate practice, all of the regulators face a still more daunting task. None has a recipe for total success, and each would benefit from improving communications with the others and from more general reforms to bank examination. These could include:

- tighter scrutiny of and, in some cases, sanctions against bank management. When management and/or major shareholders are big borrowers from their own institutions or have a record of association with other troubled institutions, supervision should be far more stringent. Bank examiners should consider making use of their PCA powers to impose a higher capital burden on closely-held institutions, especially those engaged in high-risk or insider-related lines of business;
- requiring that only the head of another regulatory agency may decline a request from the FDIC for joint examinations;
- reviewing depository institution accounting standards, especially with regard to complex securitization-related assets and derivatives exposures. Bank regulators have long resisted market-value accounting because this could expose institutions to earnings volatility. However, historical-cost accounting protects institutions from quick recognition of losses, which increases the likelihood of deeper losses down the road. Current accounting practices also reduce market discipline and encourage regulatory forbearance, since banks may look far healthier than they actually are;
- reinstating the report process related to high-growth institutions mandated in FIRREA. In 1995, the FDIC decided to terminate its guidance in this area, despite substantial evidence that banks that grow very fast for reasons not associated with mergers or acquisitions pose a disproportionate risk to the deposit insurance funds;
- reconsideration of the current policy against disclosure of CAMELS ratings. Bank regulators have long opposed public disclosures, fearing that this would exacerbate liquidity problems at troubled banks. However, they are proposing both within the U.S. and in the Basel process to institute a series of highly complex and, in some cases, very burdensome new disclosure requirements. A simpler disclosure with regard to a bank's condition would significantly improve market discipline, especially in the absence of a proper relationship between deposit insurance premiums and bank risk; and
- creating teams of specialized examiners on call to any federal financial supervisor. This would encourage the cost-effective development of experts in highly-complex areas such as asset securitization and the proper valuation of residuals,

while minimizing the number of duplicative exams to which institutions are subject. Regulators might also be required to have their own or to share teams of specially-trained anti-fraud examiners, whose law-enforcement orientation might improve supervision in cases like Keystone.

III. Examination Fees

It is also possible that the dependence of certain regulators on assessment fees could create problematic supervisory incentives. At present, we do not see any evidence that fees have played any role in recent supervisory decisions by the OCC and OTS. Indeed, as these agencies note, problem institutions generally cost the agencies far more in supervisory resources and, in some cases, court costs than they provide in fees. Further, both agencies experience what they call reputation risk when an institution fails on their watch, as is evident not only from today's hearing, but also from earlier ones in the House after Keystone's collapse.

However, the fact that fees are not now problematic does not mean that they won't become so in time. The consolidation in the banking industry means that the OCC and OTS are increasingly dependent on a few very large institutions for the bulk of their revenue. This is particularly true at the OTS, where one very large savings association dwarfs the rest of the industry in terms of market size and, therefore, assessment fees. Loss of such an institution to another regulator could be costly, and it is therefore possible that an agency head might be more inclined to work with such a bank than with a smaller one with less impact on the agency's bottom line.

However, while the shape of the looming problem with assessments is clear, the cure is less so. Bringing the OTS and OCC under the appropriations process is, in my view, highly ill advised. The problem with appropriating supervisory resources is evident at OFHEO, the safety-and-soundness regulator for Fannie Mae and Freddie Mac. Due to budget and other pressures, Congress consistently appropriates less for OFHEO than the agency requests, giving it far fewer resources with which to supervise its charges than is the case at the OCC and OTS for very large institutions.

The OCC has suggested that the premiums paid by national banks and federal savings associations to the FDIC be used also to pay for bank supervision, as is the case for state non-member banks. Doing so would ensure that the FDIC uses its resources wisely, while eliminating an obvious inequity between the federal and state charters. However, it is very difficult to identify precisely which portion of the FDIC's premiums should be subtracted to compensate federally-chartered institutions. Further, doing so could reduce the resources available to absorb losses to the deposit insurance funds, increasing the prospect of rapid increases in industry-wide premiums or even, under extreme circumstances, taxpayer assistance. Finally, calibrating the amount repatriated to federal supervisors would become far more difficult when truly risk-based premiums are instituted.

In light of these concerns, I recommend that:

- Congress consider the issue of federal examination fees in the context of pending proposals to reform deposit insurance. Specifically, Congress might consider allocating a portion of the premiums paid by each federally-chartered bank and savings association as a supervisory charge, rebating these fees back to the primary regulator for as long as the deposit insurance funds stay above their designated reserve ratios.