

UNNECESSARY RISK: HOW THE FDIC’S EXAMINATION POLICIES THREATEN THE SECURITY OF THE BANK INSURANCE FUND

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I.

INTRODUCTION

“Deposits Federally Insured to \$100,000—Backed by the Full Faith and Credit of the United States Government.” Almost every American with a bank account will immediately recognize this phrase. Yet for most, this federal insurance guarantee carries little meaning for

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their everyday life. In the seven decades since Congress created the Federal Deposit Insurance Corporation (FDIC) to protect depositors, widespread bank collapses have become relatively rare, and only once has the insurance pool which protects most bank accounts—the Bank Insurance Fund—become insolvent.¹

This single unprecedented period of insolvency at the end of the Gordon Gekko era² shocked the nation.³ If an insurance fund becomes insolvent, the insurer naturally cannot pay out current and future claims against the pool. As such, for this two-year period, the FDIC could not live up to its promise to guarantee the bank accounts of the American public—if a bank were to collapse, an account holder faced the possibility of losing everything.

Congressional response to the near collapse of bank depositors' safety net was swift. The subsequent congressional investigations determined that infrequent audits by agency examiners played a major role in the crises that led to this collapse.⁴ Specifically, during the 1980s, the financial regulatory agencies ended their past practice of auditing financial institutions' books on a yearly basis, arguing that new mathematical formulas and computer processing abilities made such annual examinations largely unnecessary.⁵ The subsequent crises highlighted the imprudence of allowing financial institutions to self-report their financial situation—increasing the period between on-

1. At the close of 1991 and 1992, the Bank Insurance Fund had a negative balance of \$7 billion and \$101 million respectively. See *Commercial Banks Show Record Profits*, 59 BANKING REP. (BNA) No. 9, at 330 (Sept. 14, 1992); Press Release, Fed. Deposit Ins. Corp., Bank Insurance Fund Grew to \$13.1 Billion at Year-End, Preliminary Data Show, PR-14-94 (Feb. 22, 1994), available at <http://www.fdic.gov/news/news/press/1994/pr9414.html>. This condition of liabilities exceeding assets and the inability to pay debts as they mature is considered "insolvency." BLACK'S LAW DICTIONARY 811–12 (8th ed. 2004). Congress merged the Bank Insurance Fund and the Savings Association Insurance Fund into a new fund, the Deposit Insurance Fund, on March 31, 2006. See Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109-171, § 2102, 120 Stat. 9, 9 (2006); Revisions to Reflect Merger, 71 Fed. Reg. 20,524 (Apr. 21, 2006).

2. Michael Douglas played a fictitious Wall Street investment banker named Gordon Gekko in the 1987 film *Wall Street*. WALL STREET (20th Century Fox 1987). His "Greed is good" speech has come to symbolize the investment banking industry during the late 1980s.

3. See Nathaniel C. Nash, *Who to Thank for the Thrift Crisis*, N.Y. TIMES, June 12, 1988, at F1 (describing the beginning of the "financial disaster" and the initial finger-pointing); Leslie Wayne, *Where Were the Accountants?*, N.Y. TIMES, Mar. 12, 1989, at F1 (questioning how one of the "biggest financial calamities this country has ever seen" went undetected); Charles Schumer, Op-Ed., *The S&L Horror Show: Act II*, N.Y. TIMES, July 24, 1990, at A21 (describing public outrage, executive branch inaction, and massive financial losses during the financial emergency).

4. See *infra* notes 59–62 and accompanying text.

5. See *infra* notes 44–46 and accompanying text.

site examinations provided too strong a temptation for banks to “cook” their books to cover mounting financial losses. To prevent the regulatory agencies from repeating this mistake, Congress mandated a yearly examination requirement for the entire banking industry.⁶ By revoking agency discretion, Congress intended to ensure the safety and soundness of the banking industry through routine on-site monitoring by the FDIC and its sister agencies.⁷

This Note argues that over the last ten years the FDIC’s ability to ensure the safety and soundness of the U.S. banking industry has once again been significantly undermined. Bowing to pressure from the banking industry, Congress and the FDIC have instituted high-risk policies that threaten the integrity of the U.S. financial system.

Part II provides background on the U.S. system of banking supervision. Part III discusses the wave of banking collapses in the 1980s and summarizes the lessons learned about the bank supervisory system. Part IV turns to the specific policies and regulations instituted by Congress and the FDIC in recent years that have undermined the FDIC’s ability to effectively monitor state non-member banks. These policies include the agency’s decision to reduce examination resources while simultaneously increasing the number of banks exempt from frequent on-site examinations. Part V shows the effect that these policies have had on the FDIC’s ability to effectively discharge its regulatory duties. Specifically, these policies have undermined the agency’s ability to: (1) prevent banking crises from occurring and (2) adequately respond to those crises that do occur. Part VI presents arguments that the current policies will not actually prohibit the FDIC from preventing or responding to future bank collapses as well as counter-arguments. Part VII concludes by arguing that to ensure the effectiveness of our banking system supervision, the FDIC must ramp up examination staff and increase the frequency of safety and soundness examinations.

6. See *infra* notes 63–67 and accompanying text; Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, Pub. L. No. 102-242, § 111, 105 Stat. 2236, 2240–41 (codified at 12 U.S.C. § 1820(d) (2000)).

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7. See Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (passed, in part, “to improve supervision and examinations”); *id.* § 111(d), 105 Stat. at 2240 (entitled “Annual On-Site Examinations of All Insured Depository Institutions Required” under the subtitle “Supervisory Reforms”); *infra* notes 63–67 and accompanying text. The banking agencies are required to prescribe a variety of regulations to ensure the safety and soundness of depository institutions, ranging from managerial oversight to risk exposure. See 12 U.S.C. § 1831p-1 (2000). The agencies engage in examinations of financial institutions to determine whether they pose a risk to the insurance pool—whether they are safe and sound. See 12 C.F.R. § 364 app. A.

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II.

A BRIEF HISTORY OF THE FDIC

The United States heavily regulates its banking industry, requiring financial institutions not only to obtain a charter from either a state or the federal government but also to subject themselves to federal agency oversight.⁸ Three separate agencies share responsibility for supervising and regulating all commercial banks—the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC). The OCC regulates and supervises banks chartered by the federal government,⁹ while the FRB regulates state-chartered banks that are members of the Federal Reserve System.¹⁰ All remaining state non-member banks are supervised and monitored by the FDIC.¹¹ This last agency, which maintains the Bank Insurance Fund (BIF)—now known as the Deposit Insurance Fund (DIF)¹²—while simultaneously monitoring almost 65% of the commercial banks it insures,¹³ is the focus of this paper.

Historically, banking crises are hardly a rare phenomenon. Indeed, before the creation of the FDIC, the United States experienced banking panics roughly every ten to fifteen years.¹⁴ Many of these panics involved reflexive “bank runs”¹⁵ brought on by public percep-

8. See Christine E. Blair & Rose M. Kushmeider, *Challenges to the Dual Banking System: The Funding of Bank Supervision*, 18.1 FDIC BANKING REVIEW 1, 1–4 (2006) (describing the dual state and federal banking system); see also Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 683–89 (1988) (critiquing the dual system).

9. See 12 U.S.C. § 93 (2000) (empowering the Comptroller of the Currency to enforce Chapter 2 of Title 12 of the United States Code); OCC: About the OCC, <http://www.occ.treas.gov/aboutocc.htm> (last visited Nov. 30, 2006).

10. See 12 U.S.C. § 248 (2000) (enumerating the powers of the Federal Reserve Board); The Fed. Reserve Bd., *The Structure of the Federal Reserve System*, <http://www.federalreserve.gov/pubs/frseries/frseri.htm> (last visited Nov. 30, 2006).

11. See 12 U.S.C. § 1819 (2000) (enumerating the powers of the FDIC); *id.* § 248(a)(1) (directing state nonmember banks to report to the FDIC); FDIC: Who is the FDIC?, <http://www.fdic.gov/about/learn/symbol/index.html> (last visited Nov. 30, 2006).

12. See Federal Deposit Insurance Reform Act of 2005 § 2102, Pub. L. No. 109-171, 120 Stat. 9, 9 (2006).

13. FED. DEPOSIT INS. CORP., *STATISTICS AT A GLANCE: LATEST INDUSTRY TRENDS* (Sept. 2006), <http://www.fdic.gov/bank/statistical/stats/2006sep/industry.pdf>.

14. See, e.g., Daniel W. Levy, *A Legal History of Irrational Exuberance*, 48 CASE W. RES. L. REV. 799, 804 (1998) (“The impressive streak begins with the Panic of 1819 and continues with the Panics of 1837, 1857, 1869, 1873, 1884, 1893, 1907, and the Great Depression of 1929.”).

15. A “bank run” is a situation where a significant number of a bank’s depositors seek to withdraw their money simultaneously. A run, normally precipitated by a growing belief in a bank’s insolvency, consists of individual depositors attempting to

tions of bank insolvency.¹⁶ This period of U.S. banking history reached its peak in the Great Depression, when over nine thousand banks failed in just four years.¹⁷

After this catastrophic collapse, Congress created the FDIC in order to increase stability in the banking system.¹⁸ By charging the FDIC with the task of insuring the deposits of banks and savings institutions, Congress sought to promote public confidence in the U.S. financial system, thereby preventing future runs on banks. In order to effectively protect the BIF, Congress provided the FDIC with two important tools. First, the FDIC is empowered to monitor and examine insured institutions in order to identify and detect risks early on.¹⁹ Second, the FDIC has the ability to close and take over insolvent institutions in order to mitigate losses to the insurance pool.²⁰

When a collapse does occur, the FDIC's preferred method for dealing with a collapsed institution is to close the doors on a Friday afternoon.²¹ The agency then spends the entire weekend arranging the

save their own deposits before the bank goes under. Since banks normally only keep a fraction of the cash necessary to repay deposits on hand at any given time, such runs often turn into a self-fulfilling prophecy. *See generally* Mark E. Van Der Weide & Satish M. Kini, *Subordinated Debt: A Capital Markets Approach to Bank Regulation*, 41 B.C. L. REV. 195, 200-06 (2000) (describing bank runs as part of a larger article opposing federal deposit insurance).

16. *See* Steven Ramirez, *Depoliticizing Financial Regulation*, 41 WM & MARY L. REV. 503, 531 (2000); Lori Anne Czepiel, Note, *Best Efforts Underwriting: Does Glass Steagall Allow It?*, 7 ANN. REV. BANKING L. 557, 577 (1988).

17. FED. DEPOSIT INS. CORP., A BRIEF HISTORY OF DEPOSIT INSURANCE IN THE UNITED STATES 1 (1998), available at <http://www.fdic.gov/bank/historical/brief/brhist.pdf>.

18. *See* Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.) (stating in its preamble the intent "[t]o provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes"); FED. DEPOSIT INS. CORP., THE FIRST FIFTY YEARS: A HISTORY OF THE FDIC 1933-1983, at 40-43 (1984) (describing the legislative efforts to enact deposit insurance). The banking industry opposed the creation of deposit insurance, and the FDIC by implication, believing it to be "unsound, unscientific, and dangerous." *Id.* at 41 (citing *Wires Banks to Urge Veto of Glass Bill*, N.Y. TIMES, June 16, 1933, at 14).

19. *See* 12 U.S.C. §§ 1819(a), 1820(b), 1831m (2000) (empowering the FDIC to make examinations and require reports); OFFICE OF THE COMPTROLLER OF THE CURRENCY, PROBLEM BANK IDENTIFICATION, REHABILITATION, AND RESOLUTION: A GUIDE FOR EXAMINERS 1 (2001) (describing the importance of early problem detection in mitigating risk).

20. *See* 12 U.S.C. §§ 1811(b), 1819(a), 1831o (2000) (providing the FDIC the power to act as receiver of insolvent institutions, to liquidate their assets, and laying out statutory requirements for prompt corrective action).

21. *See* OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., AUDIT REP. NO. 03-041, INSURANCE DETERMINATION CLAIMS PROCESS 27 (Sept. 17, 2003), <http://fdicoig.gov/reports03/03-041.pdf> (diagramming the insurance claim process); Paul Lund, *The Decline of Federal Common Law*, 76 B.U. L. REV. 895, 951 n.233 (1996) ("State or

sale of the institution's deposits and loans to a solvent competitor.²² On Monday morning, customers of the failed institution discover that they have seamlessly become customers of the assuming institution, but otherwise nothing has changed.²³

For almost fifty years, this system effectively limited the impact of bank collapses on the overall banking system. During its first seven years of operation, the FDIC handled an average of fifty failures annually as it dealt with the fallout from its pre-inception period.²⁴ By the early 1940s, the number of bank failures dropped dramatically.²⁵ Over the next three decades, bank failures became relatively rare, averaging fewer than five annually.²⁶ Those failures that did occur tended to be caused by fraud rather than by financial risk-taking.²⁷

III.

THE BANKING CRISES ERA: 1980–1994

Until the late 1970s, the banking industry appeared relatively healthy. Few banks showed clear signs of the impending crises that lay ahead.²⁸ By the late 1970s, net returns on equity were high by historic standards and equity-to-asset ratios exceeded the levels of earlier in the decade.²⁹ Nevertheless, from 1980 to 1994, over fifteen hundred FDIC-insured banks closed or received financial assistance from the FDIC.³⁰ This number, which represented over 9% of all banks either in existence at the end of 1979 or chartered in the next fifteen years, stands in sharp contrast with the 0.3% figure for the

federal banking authorities typically close the failed institution on a Friday and reopen it for services the next Monday").

22. OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., AUDIT REP. NO. 03-041, *supra* note 21 at 27.

23. *See id.*; FDIC: Who is the FDIC?, *supra* note 11.

24. FED. DEPOSIT INS. CORP., 2004 ANNUAL REPORT 107 (2005), *available at* http://www.fdic.gov/about/strategic/report/2004annualreport/index_pdf.html [hereinafter FDIC 2004 ANNUAL REPORT].

25. *Id.*

26. *Id.*

27. FED. DEPOSIT INS. CORP., 1 HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE 35 (1997) [hereinafter HISTORY OF THE EIGHTIES].

28. *Id.* at 5. Although bank failures increased slightly in 1975–76, the number decreased in 1977–78. *See* FDIC 2004 ANNUAL REPORT, *supra* note 24, at 107.

29. HISTORY OF THE EIGHTIES, *supra* note 27, at 5–6.

30. FDIC 2004 ANNUAL REPORT, *supra* note 24, at 107. The FDIC has reported elsewhere that the total number was actually 1,617. *See* HISTORY OF THE EIGHTIES, *supra* note 27, at 13.

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preceding fifteen-year period.³¹ At the peak of the crisis, in 1989, banks were closing at a rate of nearly four per week.³²

When the dust finally cleared, the BIF and the banking industry had spent over \$36 billion to resolve failing banks.³³ Admittedly, this number pales in comparison to the estimated \$160 billion spent to resolve the contemporaneous savings and loan crisis.³⁴ Nevertheless, these losses to the bank industry were enough to push the BIF into insolvency for the first time in its fifty-year history.³⁵ Lacking a congressional bailout provision, the FDIC could no longer guarantee the deposits in U.S. banks. Consequently, depositors faced the possibility of losing everything if their bank collapsed. This state of affairs threatened to undermine the public's confidence in the banking system and raised the possibility that depositors would engage in runs on banks at the first sign of trouble, a predicament not seen for over half a century.³⁶

Although commentators disagree as to what factor or factors caused the rise in bank failures during this time, it seems probable that a variety of forces contributed to the decade of banking crises.³⁷ These range from broad economic and regulatory trends to a series of regional and sectoral recessions.³⁸ In 1995, shortly after her confirmation, the FDIC's then-Chairman Ricki Helfer ordered an investigation

31. See HISTORY OF THE EIGHTIES, *supra* note 27, at 13.

32. See FDIC 2004 ANNUAL REPORT, *supra* note 24, at 107 (reporting 206 closures in 1989).

33. *Financial Modernization and H.R. 268, The Depository Institution Affiliation and Thrift Charter Conversion Act: Hearing Before the Subcomm. on Fin. Inst. and Consumer Credit of the H. Comm. on Banking & Fin. Serv.*, 105th Cong. (1997) (testimony of Ricki Helfer, Chairman, Federal Deposit Insurance Corporation), available at <http://www.fdic.gov/news/news/speeches/archives/1997/>.

34. *Id.* (reporting the GAO's cost estimates for the savings and loan crisis); Charles Schumer, *supra* note 3, at A21 (estimating that interest payments on the savings and loan bailout would cost the American public at least \$300 billion).

35. See *supra* note 1.

36. See *supra* notes 14–17 and accompanying text. In fact, a number of bank runs did occur. After one run on the Bank of New England in early 1991, the FDIC immediately stepped in and the run dissipated. See Steve Lohr, *When a Big Bank Went Under, U.S. Presence Stemmed the Panic*, N.Y. TIMES, Feb. 18, 1991, at A1.

37. See HISTORY OF THE EIGHTIES, *supra* note 27, at 35.

38. *Id.* at 4. One of the most significant factors was arguably the oil bust in the mid-1980s. The “oil patch” cities in areas like Texas and Oklahoma experienced economic booms after the price of oil surged at the beginning of the decade. Severe localized recessions accompanied the subsequent decline in oil price. Home prices collapsed almost forty percent in some areas. See Cynthia Angell & Norman Williams, *U.S. Home Prices: Does Bust Always Follow Boom?*, FYI: AN UPDATE ON EMERGING ISSUES IN BANKING, Feb. 10, 2005, available at <http://www.fdic.gov/bank/analytical/fyi/2005/021005fyi.html>.

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and analysis of the banking crises.³⁹ This investigation culminated in a symposium involving members of the financial community and the eventual publication of a book, *HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE*, detailing the agency's findings.⁴⁰ Of these findings,⁴¹ arguably one of the most important is that the effects of bank collapses can be mitigated by adequate supervision.⁴² Furthermore, the agency concluded that when it comes to bank supervision, there is no substitute for regular, on-site examinations.⁴³

The FDIC was hardly a stranger to such on-site examinations. In fact, until the mid-1970s, all banks received an examination approximately every twelve months.⁴⁴ But then the conservative on-site approach to the monitoring of financial institutions, which had successfully prevented a major financial crisis for almost half a century, began to be viewed as an archaic and outdated relic of a past era. With the advent of sophisticated computer systems in the mid-1970s, the FDIC and its sister agencies began to shift to off-site surveillance based on the belief that these tools adequately replaced and decreased the need for on-site visits.⁴⁵ By switching to computer automation, the agencies believed that they could reduce examination costs as well as the burden that on-site examinations imposed on banks.⁴⁶

Starting in 1976, the FDIC began to exempt non-problem banks from annual examinations.⁴⁷ By 1985, the examination period for problem banks had been extended from twelve months to between

39. *HISTORY OF THE EIGHTIES*, *supra* note 27, at iii–v.

40. *See generally id.*

41. The agency cited four specific findings: (1) the decision to reduce examination resources was a failure and “a high-risk policy,” (2) frequent on-site examinations are necessary to identify risk early, (3) early detection of problems increases the overall effectiveness of agency oversight, and (4) the examination system needs to do a better job of capturing regional economic risks. *Id.* at 462 (summarizing lessons learned by the agency). *See generally id.* at 421–76 (describing and analyzing agency enforcement policies during the late 1980s and early 1990s).

42. *See id.* at 462.

43. *Continued Hearings on Financial Modernization, Including, H.R. 10, Financial Services Competitiveness Act of 1997: Hearing Before the H. Comm. on Banking and Fin. Servs.*, 105th Cong. (1997) (statement of Ricki Helfer, Chairman, Federal Deposit Insurance Corporation), available at <http://www.fdic.gov/news/news/speeches/archives/1997/>.

44. *See HISTORY OF THE EIGHTIES*, *supra* note 27, at 422.

45. *Id.* at 422–23.

46. *Id.* at 423.

47. *Id.* at 424. The FDIC scores institutions on a 1 to 5 scale in a number of examination categories—most importantly compliance with federal regulations and safety and soundness/risk management. *See* FDIC Composite Rating Definition List, http://www.fdic.gov/regulations/examinations/ratings/FDIC_Composite_Ratings_Definition_List.pdf (last visited Nov. 30, 2006).

twelve and eighteen months while mid-quality banks were to be examined at least every twelve to twenty-four months.⁴⁸ Even more striking, though, was the extension granted to highly-rated banks. These banks had their examination periods extended from twelve months to a full thirty-six months, while banks consisting of less than \$300 million in total assets could extend this period up to five years.⁴⁹

The 1995 investigation into the crisis recognized that the decrease in examination frequency was not the only imprudent mistake made during this time period. As the agency stretched out the period between examinations, it also began to reduce examination staff, mainly through a series of hiring freezes in response to calls to reduce the size of government.⁵⁰ Between 1979 and 1985, the FDIC's field examination staff steadily declined, eventually reaching a level 25% below authorized employment levels.⁵¹ Accordingly, when bank failures began to mount, experienced examiners were in short supply. Those seasoned examiners that remained were often assigned to train new examiners, further decreasing the resources available for conducting actual examinations.⁵²

As part of its later analysis of the banking crises, the FDIC explicitly acknowledged that reducing examination staff was a "public policy failure."⁵³ As frequent on-site examinations are essential for early identification of risk and ensuring the integrity of a bank's financial reporting, reducing examination staff directly undermined the FDIC's ability to effectively monitor its banks.⁵⁴ The agency postulated that if these staffing cuts had not been made, total losses to the BIF would have been lower.⁵⁵

Defenders of the new system, on the other hand, pointed to the availability of off-site examinations as a stand-in for expensive and labor-intensive traditional on-site exams. These off-site examinations, though, rely heavily on self-reported data by the bank and its auditors⁵⁶ yet, such self-reported data are generally agreed to be less reli-

48. HISTORY OF THE EIGHTIES, *supra* note 27, at 425.

49. *Id.* Thus, a bank receiving a "1" rating for safety and soundness might only be audited once every five years.

50. *Id.* at 426.

51. *Id.* An employment authorization sets a maximum employee level. Ironically, the events of the last twenty years show that a minimum employment level would be more appropriate for the FDIC and the OCC.

52. *Id.* at 425-26.

53. *Id.* at 432.

54. *Id.* at 432, 462.

55. *Id.* at 432.

56. *See id.* at 479 (noting that off-site examinations will not be effective unless the underlying Call Report data are accurate). Every insured institution is required to file

able than traditional monitoring.⁵⁷ With the decrease in on-site examinations, this less reliable self-reporting began to represent a larger portion of the agency's overall examinations.⁵⁸

The FDIC's findings regarding its examination policies are consistent with those of the House Banking, Finance and Urban Affairs Committee's investigation into the crises.⁵⁹ The crises affected all three banking agencies: the FDIC, the FRB, and the OCC. Nevertheless, a majority of the losses originated with OCC- and FDIC-regulated institutions, which had been subject to less-frequent on-site examinations.⁶⁰ Indeed, there appeared to be an inverse correlation between on-site examination frequency and the levels of BIF losses attributable to a particular agency's institutions.⁶¹ In short, as the frequency of on-site examinations increased, the number of bank failures decreased.

To summarize, both Congress and the FDIC recognized that a decrease in on-site examinations appeared to be directly correlated with an increase in BIF losses. Furthermore, the FDIC explicitly stated that decreasing its examination force was a public policy failure. The FDIC felt that both of these decisions of the past should serve as lessons for the future.⁶²

a consolidated Reports of Condition and Income—known as a “Call Report”—each calendar quarter. *See* Voluntary Testing and Mandatory Enrollment for a New Method of Submitting the Consolidated Reports of Condition and Income, 69 Fed. Reg. 950, 951 (Jan. 7, 2004) (providing background information on Call Reports). These Call Reports, which include data ranging from income and liabilities to past due loans, present a comprehensive picture of a bank's financial situation. *See id.*

57. *See* FED. DEPOSIT INS. CORP., 2 HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE 25–26 (1997) (concluding that off-site monitoring results in substantial predictive inaccuracies); *id.* at 32 (touting the value of monitoring by private industry); HISTORY OF THE EIGHTIES, *supra* note 27, at 432 (noting that Call Report data are less reliable if examinations are less frequent). Ostensibly, self reporting, which depends on the truthfulness of the reporter, invariably entails a higher likelihood of fraud. This maxim holds with almost any subject—whether corporate insurance premiums, financial accounting, or golf scores.

58. HISTORY OF THE EIGHTIES, *supra* note 27, at 432.

59. *See* ANNE M. KHADEMIAN, CHECKING ON BANKS: AUTONOMY AND ACCOUNTABILITY IN THREE FEDERAL AGENCIES 6–7 (1996) (discussing STAFF OF H. COMM. ON BANKING, FIN. AND URBAN AFFAIRS, 102D CONG., ANALYSIS OF BANK DEPOSIT INSURANCE FUND LOSSES (Sept. 1991)).

60. *Id.* at 7.

61. National banks under the supervision of the OCC, which had been a leader in instituting new, more lenient examination practices and only examined 36% of banks on-site, accounted for 73% of the losses. The FRB, on the other hand, examined 97% of its banks on-site; its member banks not only did not result in significant losses, but they actually contributed more money to the BIF than was required. The FDIC fell between these two, with 64% on-site examinations and 35% of all losses. *See id.*

62. *See* HISTORY OF THE EIGHTIES, *supra* note 27, at 462.

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IV.

IGNORING THE LESSONS OF THE PAST

Although tempered during the peak years of the banking crises, the push by financial institutions for decreased regulation never fully abated. It is not surprising, therefore, that the protections and safeguards enacted by Congress in response to the crises have slowly been eroded while the lessons learned by the FDIC have slowly been forgotten. In the last few years, two significant factors behind the FDIC's failure to adequately mitigate the risk posed by the financial excesses of the 1980s—infrequent examinations and inadequate staffing—have once again become relevant issues.

*A. Congress and the Agencies Extend the Examination Cycle**1. The FDICIA's Small Bank Exemption*

In response to the House Committee findings, Congress revoked all three agencies' discretion in setting the examination interval for banks when it passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).⁶³ The FDICIA required annual "safety-and-soundness" examinations for all insured institutions.⁶⁴ Only well-capitalized institutions with less than \$100 million in assets were allowed an extended schedule of eighteen months.⁶⁵ Most importantly, a full on-site examination during the examination cycle was required for all institutions.⁶⁶ The drive-by style of examination favored by the OCC, and to some extent the FDIC, was explicitly cited as the reason for the OCC's lower success rate in preventing bank failures.⁶⁷ Going forward, all agencies would now be required to follow the FRB's policy of yearly examinations.

Section 111 of the FDICIA, however, authorized an eighteen-month cycle for certain banks with a composite rating of "1" under the Uniform Financial Institutions Rating System (UFIRS)⁶⁸ and total assets of \$100 million or less.⁶⁹ In 1994, only three years after the

63. Pub. L. No. 102-242, 105 Stat. 2236 (codified throughout 12 U.S.C. (2000)).

64. *Id.* § 111(a) (codified at 12 U.S.C. § 1820(d)).

65. *Id.*

66. *Id.*

67. KHADEMIAN, *supra* note 59, at 8.

68. See Uniform Financial Institutions Rating System, 62 Fed. Reg. 752 (Jan. 6, 1997) (describing the UFIRS in great detail as part of the adoption of proposed revisions to the system).

69. FDICIA § 111(a). See also Expanded Examination Cycle for Certain Small Insured Institutions, 63 Fed. Reg. 16,378, 16,378 (Apr. 2, 1998) (stating "outstanding" amounts to a "UFIRS 1" rating while "satisfactory" is akin to a "UFIRS 2"). The FDIC gives only those banks most capable of withstanding financial shocks their

FDICIA was enacted, Congress enacted the Riegle Community Development and Regulatory Improvement Act of 1994,⁷⁰ which lowered the composite rating requirement necessary to qualify for the eighteen-month examination from “1” to “2.”⁷¹ At the same time, eligibility for the eighteen-month cycle was extended to banks with composite ratings of “1” and assets of \$250 million or less.⁷² Remarkably, this expansion of the examination exemption was less than what the House originally proposed. The initial bill actually had proposed to increase the examination interval to a full twenty-four months.⁷³

This wave of exemption growth peaked in 1998 when all three agencies, pursuant to a 1996 congressional authorization,⁷⁴ extended the eighteen-month examination cycle to any bank with \$250 million or less and a composite rating of “2” or higher.⁷⁵ This represented the

highest composite rating of “1.” Banks on the opposite end of the spectrum, those facing impending collapse, receive the lowest possible rating of “5.” See FDIC Composite Rating Definition List, *supra* note 47.

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70. Pub. L. No. 103-325, 108 Stat. 2160 (1994). As a historical aside, Senator Riegle, the Act’s namesake, was both one of the Keating Five and chairman of the Senate Banking Committee. See Nathaniel C. Nash, *Senator Defends Help for Lincoln*, N.Y. TIMES, Apr. 9, 1990, at D1 (describing Riegle’s role in the scandal). In the midst of the S&L crisis of the 1980s, the Senate Ethics Committee investigated allegations that these senators attempted to interfere with the Federal Home Loan Bank Board’s investigation into the failed Lincoln Savings and Loan Association. See Richard L. Berke, *Riegle Plays Down Ties with Keating*, N.Y. TIMES, Jan. 8, 1991, at A16 (describing Riegle’s evasiveness and claimed lack of memory). One senator, Alan Cranston, was censured while the other four were criticized for questionable conduct. See Op-Ed, *Senator Riegle’s Duty*, N.Y. TIMES, Nov. 26, 1991, at A20 (labeling the response by the Ethics Committee “spineless” and calling Riegle’s continued chairmanship of the Banking Committee shameful). Riegle subsequently chose not to seek reelection when his term ended in 1994. See Martin Tolchin, *Michigan Senator in Savings Scandal Will Retire*, N.Y. TIMES, Sept. 29, 1993, at A16 (citing increased family obligations).

71. § 306, 108 Stat. at 2217. See also Expanded Examination Cycle for Certain Small Insured Institutions, 63 Fed. Reg. at 16,378 (describing this history).

72. See *supra* note 71.

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73. Economic Growth and Financial Institutions Regulatory Paperwork Reduction Act, H.R. 962, 103d Cong. § 301 (1993). This section of the bill was ironically titled “Unnecessary Cost, Paperwork and Regulation.”

74. Section 2221 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 amended section 10(d) of the Federal Deposit Insurance Act (FDI Act) to provide that at any time after September 23, 1996, U.S. bank supervisory agencies could extend the 18-month examination cycle to certain national banks and state banks with a composite rating of 2 or higher and total assets of \$250 million or less “if the agency determines that the greater amount would be consistent with the principles of safety and soundness for insured depository institutions.” Pub. L. No. 104-208, Tit. II, § 2221, 110 Stat. 3009 (1996); see Expanded Examination Cycle for Certain Small Insured Institutions, 63 Fed. Reg. at 16,379.

75. Expanded Examination Cycle for Certain Small Insured Institutions, 63 Fed. Reg. at 16,379.

formal adoption of a proposed rule published the year before, which claimed the extension was warranted due to the agencies' reliance on "off-site monitoring tools to identify potential problems in smaller, well-managed institutions that present low levels of risk."⁷⁶ The agencies further justified their actions based on the belief that their risk management assessment provided reasonable assurance that qualifying institutions could "deal effectively" with any changes that might occur between examinations.⁷⁷ Ironically, the FDIC failed to mention that it had recently come to the exact opposite conclusion in its exhaustive analysis of the 1980s banking crises, which it had just released the prior year.⁷⁸

The proposed rule from which this formal expansion arose resulted in sixteen comments, six from banking institutions, six from Federal Reserve Banks, and four from trade associations.⁷⁹ Most were in favor of the expansion of eligibility for the eighteen-month cycle.⁸⁰ This rule extended the exemption to over one thousand additional institutions, including 497 FDIC-regulated banks.⁸¹ With the number of exempt institutions greatly expanded, the pressure for further exemptions was temporarily alleviated. The years immediately following ushered in a period of relative stability, as Congress passed no additional amendments to the scope of the small bank exemption for almost a decade. In 2005, though, this period of stability came to an end.

2. *The Financial Services Regulatory Relief Act of 2005*

As the crises of the late 1980s have faded further into the past, the banking industry has begun to petition Congress to remove the regulatory burdens with which it now finds itself shackled. Proponents of decreased regulation point to the over eight hundred regulations promulgated by the regulatory agencies in the last fifteen years.⁸²

76. Expanded Examination Cycle for Certain Small Insured Institutions, 62 Fed. Reg. 6449, 6451 (proposed Feb. 12, 1997).

77. *Id.*

78. See *supra* Part III; HISTORY OF THE EIGHTIES, *supra* note 27 (published in 1997).

79. Expanded Examination Cycle for Certain Small Insured Institutions, 63 Fed. Reg. at 16,379.

80. *Id.*

81. Expanded Examination Cycle for Certain Small Insured Institutions, 62 Fed. Reg. at 6451.

82. See *Financial Services Regulatory Relief: The Regulator's Views: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 2-3 (2005) (statement of Rep. Jeb Hensarling, Member, Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.).

They further cite statistics indicating that bank regulatory compliance accounts for 12–13% of the banking industry's non-interest expenses.⁸³

This burden, though, does not originate with the examination requirements imposed after the crises of the 1980s. Rather, the majority of the increased regulatory burden is actually rooted in legislation enacted by Congress to combat money laundering—specifically, the Bank Secrecy Act and the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT Act).⁸⁴ Congress, under the pretext of combating drug dealers and terrorists, now requires banks to monitor all financial transactions in order to identify suspicious financial activity.⁸⁵

When a bank believes a transaction amounting to \$5000 or more involves criminal activity, the bank must file a Suspicious Activity Report (SAR) with the Financial Crimes Enforcement Network (FinCEN).⁸⁶ Because failure to file a SAR carries a heavy penalty, banks have engaged in what FinCEN describes as defensive filing—unjustified filings done solely to ensure that a bank is never subject to disciplinary action.⁸⁷ The sheer number of defensive filings has made

83. *Id.* at 1 (statement of Rep. Spencer Bachus, Chairman, Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.).

84. *See, e.g., Financial Services Regulatory Relief: Private Sector Perspectives: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 10 (2005) (statement of Terry J. Jorde, President and CEO, Independent Community Bankers of America) (“[The Bank Secrecy Act] is topic 1(A) when bankers discuss regulatory burden.”); *Financial Services Regulatory Relief: The Regulator's Views: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 3 (2005) (statement of Rep. Jeb Hensarling, Member, Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.) (“Last month we heard where some community banks hire two to three employees to do nothing, nothing but Bank Secrecy Act compliance.”).

85. *See* 12 C.F.R. §§ 353.1, 353.3 (2005) (requiring Suspicious Activity Report filing for state non-member banks regulated by the FDIC); 12 C.F.R. § 21.11 (2005) (requiring Suspicious Activity Report filing for all national banks regulated by the OCC); 12 C.F.R. § 208.62 (2005) (requiring Suspicious Activity Report filing for all member banks regulated by the FRB).

86. *See supra* note 85. FinCEN is a division of the Department of the Treasury tasked with ensuring the safety of the financial system, including the administration of the Bank Secrecy Act. *See* FinCEN, About FinCEN: Mission, http://www.fincen.gov/af_mission.html (last visited Feb. 15, 2007).

87. *See, e.g.,* William J. Fox, Dir., FinCEN, U.S. Dep't of the Treasury, Remarks at American Bankers Association / American Bar Association Money Laundering Enforcement Seminar 3–5 (Oct. 25, 2004), *available at* <http://www.fincen.gov/fox102504.pdf>.

SARs all but useless for combating money laundering.⁸⁸ In fact, the number of SAR filings increased over 1000% between 1996 and 2004.⁸⁹ This increased burden resulted in widespread calls for money-laundering reform and relief from the banking industry.⁹⁰

Congressional response to the regulatory plight of the financial industry came in July 2005 in the form of H.R. 3505, the Financial Services Regulatory Relief Act of 2005.⁹¹ One of the bill's main features was that it instructed the Secretary of the Treasury to conduct a study on how best to reform the SAR and currency transaction reporting system.⁹² But H.R. 3505 was not limited to these necessary alterations to the money laundering regulations. The bill included a provision that would have returned to the regulatory agencies a significant portion of the discretion that they enjoyed in setting the length of examination cycles prior to the crises of the 1980s.⁹³

Two sections of the bill specifically dealt with the on-site examination cycle. The first, section 607, expanded the eligibility for the eighteen-month examination cycle by raising the "small-bank" exemption from \$250 million to \$1 billion.⁹⁴ The agencies submitted a proposal to raise the exemption limit to \$500 million in order to decrease the number of examination hours; this section actually went beyond the discretion sought by the agencies.⁹⁵

88. See *Financial Services Regulatory Relief: The Regulators' Views: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 34 (2005) (statement of Rep. Spencer Bachus, Chairman, Subcomm. on Fin. Insts. and Consumer Credit) (claiming law enforcement agencies have stated that defensive SAR filings make anti-money laundering efforts almost impossible).

89. FINCEN, *THE SAR ACTIVITY REVIEW: BY THE NUMBERS 1* (2005), reprinted in *Financial Services Regulatory Relief: The Regulators' Views: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 224, 227 (2005).

90. Suggestions include raising the SAR reporting requirement from \$5000 to \$10,000. See *Financial Services Regulatory Relief: The Regulators' Views: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 34 (2005) (statement of Rep. Spencer Bachus, Chairman, Subcomm. on Fin. Insts. and Consumer Credit).

91. H.R. 3505, 109th Cong. (2005).

92. *Id.* § 701(c).

93. *Id.* §§ 601, 607.

94. *Id.* § 607.

95. See *H.R. 3505, Financial Services Regulatory Relief Act of 2005: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 7–8 (2005) (statement of William F. Kroener, III, General Counsel, Federal Deposit Insurance Corporation) ("The interagency proposal raises the total assets ceiling for small institutions to qualify for an 18-month examination cycle from \$250 million to \$500 million, thus potentially permitting more institutions to qualify for less frequent examinations. Section 607 of H.R. 3504 raises the asset

The greater allocation of agency discretion, though, was found in section 601, which would have allowed the agencies to waive the examination schedule when they deemed it necessary in order to allocate resources in a manner that provides for the “safety and soundness” of insured institutions.⁹⁶ This waiver would potentially return to the agencies the complete discretion that they possessed before the banking crises of the 1980s, yet the sponsors of the bill provided minimal direction as to what situations would justify departure from the normal twelve-month examination cycle. The only limit to the agencies’ discretion seems to be that the departure be necessary to ensure the “safety and soundness” of their regulated institutions,⁹⁷ a restriction of little meaning since almost every action taken by the agencies must be done in order to ensure the “safety and soundness” of the financial system.⁹⁸ Indeed, such a restraint on agency action has bound the regulatory agencies since their inception. Such a vague delegation of authority to the agencies effectively removes all restraints upon their ability to alter the examination cycle as they see fit.

Admittedly, neither of these proposed statutory changes allowed the FDIC and its sister agencies to stray from the twelve-month cycle

ceiling to \$1 billion; the FDIC supports this higher amount.”), *available at* <http://financialservices.house.gov/media/pdf/092205wk.pdf>.

96. H.R. 3505 § 601. Given the significance of this provision, it is surprising that there has been almost no agency comment on this portion of the bill. The regulatory agencies often provide detailed comments on any legislation that will affect the banking industry. This provision, which would have returned significant discretion to the agencies, warranted at least some discussion by the heads of the relevant agencies. That said, when similar language was included in a 2002 legislative proposal, H.R. 3951, 107th Cong. § 601 (2002), the re-granting of examination cycle discretion enjoyed the support of at least one of the bank regulatory agencies as well as the support of the Office of Thrift Supervision. *H.R. 1375—The Financial Services Regulatory Relief Act of 2003: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 108th Cong. 139 (2003) (statement of Julie L. Williams, Chief Counsel, Office of the Comptroller of the Currency); *id.* at 58 (statement of Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision) (“OTS strongly supports the proposal to give additional flexibility to permit the federal banking agencies to adjust the examination cycle for depository institutions.”). It is unclear whether the FDIC or the FRB supported this proposal.

97. H.R. 3505, 109th Cong. § 601 (2005) (“(5) WAIVER OF SCHEDULE WHEN NECESSARY TO ACHIEVE SAFE AND SOUND ALLOCATION OF EXAMINER RESOURCES.—Notwithstanding paragraphs (1), (2), (3), and (4), an appropriate Federal banking agency may make adjustments in the examination cycle for an insured depository institution if necessary to allocate available resources of examiners in a manner that provides for the safety and soundness of, and the effective examination and supervision of, insured depository institutions.”). No further guidance was given as to when examiners could waive the required examinations.

98. See 12 U.S.C. § 1831p-1 (2000) (tasking the banking agencies with promulgating safety and soundness standards). See generally 12 U.S.C. §§ 1–1835 (2000) (encompassing the enabling statutes of the respective agencies).

without some prior justification. Rather, H.R. 3505 would have only authorized the FDIC to disregard the statutory period if the FDIC believed regulatory conditions so require.⁹⁹ In the absence of such conditions, the FDIC would remain bound to the normal twelve-month cycles.

Arguably, such regulatory conditions currently exist due to FDIC staffing policy. Over the last ten years, the FDIC has cut its staff to the point where there are no longer enough examiners to effectively audit all covered financial institutions.¹⁰⁰ Unless the agency hires additional examiners in the very near future, prudence will demand the departure from yearly examination of “sound” institutions so that the agency can focus its limited resources on troubled institutions.

Although H.R. 3505 was passed by the House, it died in the Senate Committee on Banking, Housing, and Urban Affairs.¹⁰¹ Senator Mike Crapo (ID) then sponsored a related bill, S. 2856, which incorporated many aspects of H.R. 3505.¹⁰² Both the Senate and the House passed S. 2856 unanimously without any amendments as the Financial Services Regulatory Relief Act of 2006.¹⁰³ Like H.R. 3505, S. 2856 expanded the eligibility for the eighteen-month examination cycle.¹⁰⁴ The exemption amount, though, was raised to \$500 million, as originally proposed by the regulatory agencies, rather than the \$1 billion proposed by H.R. 3505. Most notably, S. 2856 did not contain a provision equivalent to section 601 of H.R. 3505, which effectively granted the agencies the power to waive the otherwise mandatory yearly examinations for any institution. This does not mean that it will not reappear in a future bill, especially since it has now been proposed more than once in a relatively short time period.¹⁰⁵

B. A Return to Downsizing

The FDIC responded to the crises of the 1980s by immediately rebuilding its examiner staff.¹⁰⁶ At the end of 1984, total FDIC staff-

99. H.R. 3505 § 601.

100. *See infra* Part IV.B.

101. THOMAS (Library of Congress), <http://thomas.loc.gov/cgi-bin/bdquery/z?d109:HR03505:@@R> (last visited May 9, 2007).

102. THOMAS (Library of Congress), S. 2856, <http://thomas.loc.gov/cgi-bin/bdquery/z?d109:S.2856>: (last visited May 9, 2007).

103. *See* 152 CONG. REC. S5272 (daily ed. May 25, 2006); 152 CONG. REC. H7593 (daily ed. Sept. 27, 2006).

104. *See* Financial Services Regulatory Relief Act of 2006, S. 2856, 109th Cong. § 605 (2006), *reprinted in* 152 CONG. REC. S5275 (daily ed. May 25, 2006).

105. *See* H.R. 3951, 107th Cong. § 601 (2002); H.R. 3505, 109th Cong. § 601 (2005).

106. *See supra* Part III.

ing was 5076, of which eighteen hundred were in the Division of Bank Supervision.¹⁰⁷ By 1991, total staffing had increased by almost 350% to 22,586, including a 110% staffing increase in the newly renamed Division of Supervision.¹⁰⁸ As the FDIC rebuilt its examination staff, the average interval between examinations, which had grown during the 1980s, shortened once again.¹⁰⁹

By 1993, the wave of bank failures had begun to subside, and the FDIC found itself overstaffed. As problem banks were closed and their accounts liquidated, the overall receivership workloads began to decline.¹¹⁰ From 1992 to 1993, the total number of failed and assisted banks declined 66%—a decrease that coincided with a reduction in the FDIC's forecasted future closing.¹¹¹

The FDIC responded to this reduced workload by shrinking its staffing level. The agency accomplished this reduction through a combination of the expiration of temporary appointments, attrition, and employee buyouts.¹¹² The results of this program can be fairly described as dramatic. Since 1992, the total number of FDIC employees has decreased almost 80%.¹¹³ This decrease in headcount was not limited to positions involving receivership of failed institutions but extended throughout the agency, including the Department of Supervi-

107. See FED. DEPOSIT INS. CORP., *MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE, CHRONOLOGICAL OVERVIEW*, ch. 7, <http://www.fdic.gov/bank/historical/managing/Chron/> [hereinafter *MANAGING THE CRISIS*]. Although the total Department of Supervision headcount was 1800, examiners accounted for only 1389 of the total staff. See *HISTORY OF THE EIGHTIES*, *supra* note 27, at 426. Due to later restructuring in the agency, it is not possible to directly compare current examination staffing to pre-2002 numbers. See *infra* note 114.

108. *MANAGING THE CRISIS*, *supra* note 107, at ch. 14. The Division of Bank Supervision was renamed the Division of Supervision in 1989. *Id.* at ch. 12.

109. *Id.* at ch. 11 (“In 1988, the FDIC continued to make progress in achieving its two main supervision objectives, more frequent examination of banks and more prospective supervision. That was accomplished by increasing the number of safety and soundness examinations and increasing the number of examiners.”).

110. *Id.* at ch. 17 (“[D]ownsizing was in response to the decreased workload from bank failures and the eventual transfer of operations and personnel from the RTC.”).

111. *Id.* at ch. 16. The FDIC makes projections as to the number of institutions that it believes pose a reasonable possibility of failure. As the number of actual bank failures decreases and the economy improves, the FDIC revises its estimates of near-term bank failures accordingly. See, e.g., FED. DEPOSIT INS. CORP., 2005 ANNUAL REPORT 53–54 (2006), available at <http://www.fdic.gov/about/strategic/report/2005annualreport/> [hereinafter *FDIC 2005 ANNUAL REPORT*].

112. See, e.g., FED. DEPOSIT INS. CORP., 1998 ANNUAL REPORT 42–43 (1999), available at <http://www.fdic.gov/about/strategic/report/98Annualpdf/> (discussing agency downsizing and consolidation).

113. FED. DEPOSIT INS. CORP., *STATISTICS AT A GLANCE: HISTORICAL TRENDS* (Sept. 2006), <http://www.fdic.gov/bank/statistical/stats/2006sep/fdic.pdf> (falling from 22,459 in 1992 to only 4567 as of September 2006).

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sion. Between 1991 and 2006, the total number of employees involved in bank supervision declined almost 50%.¹¹⁴ Thus, both the total headcount and the Division of Supervision headcount have fallen to levels not seen since just prior to the banking crises of the 1980s.¹¹⁵ Although the FDIC needed to cut back on staffing after the wave of bank failures subsided, this reduction has gone beyond any level justified by the decrease in workload. Indeed, Part V will argue that agency staffing reached adequate levels sometime in the late 1990s. The agency's staffing cuts since 2001 appear to have gone beyond a trimming of fat and have now begun to cut into the bone.

V.

SIGNS OF STRAIN

To evaluate whether cuts in examination staff have affected the agency's ability to perform its regulatory function, we can posit three measurements of the agency's health. First, how many hours does the agency devote to on-site examinations? Second, how has the agency's workload changed over the last ten years, and how has the agency responded to these changes? Finally, does the agency have the necessary resources in place to deal with future shocks to the financial system?

114. In 1991, 3813 employees worked in the Department of Supervision. *See* MANAGING THE CRISIS, *supra* note 107, at ch. 14. On June 30, 2002, the Division of Supervision and the Division of Compliance and Consumer Affairs were merged into the new Division of Supervision and Consumer Protection. *See* FED. DEPOSIT INS. CORP., 2002 ANNUAL REPORT 126 (2003), *available at* <http://www.fdic.gov/about/strategic/report/2002annualreport/2002ar.pdf>. As such, it is impossible to directly compare current staffing numbers to those from before the merger. However, the staffing ratios between these two divisions remained relatively consistent from 1995 to 2002, with Division of Supervision staff accounting for 76–77% of the overall total. *See* FED. DEPOSIT INS. CORP., 1996 ANNUAL REPORT (1997), *available at* <http://www.fdic.gov/about/strategic/report/1996/internal.html>; FED. DEPOSIT INS. CORP., 1998 ANNUAL REPORT 43 (1999), *available at* <http://www.fdic.gov/about/strategic/report/98Annualpdf>; FED. DEPOSIT INS. CORP., 2001 ANNUAL REPORT: CORPORATE STAFFING (2002), *available at* <http://www.fdic.gov/about/strategic/report/2001annualreport/staffing.html>. The estimated 50% decline in the total number of employees involved in supervision is based on 75–80% of the combined Division's total staffing of 2517 in 2006. *See* FED. DEPOSIT INS. CORP., 2006 ANNUAL REPORT 123 (2007), *available at* <http://www.fdic.gov/about/strategic/report/2006annualreport/> [hereinafter FDIC 2006 ANNUAL REPORT].

115. Supervision staff and total staff numbered: 2129 and 3504 in 1982; 2053 and 3846 in 1983; and 1800 and 5076 in 1984. MANAGING THE CRISIS, *supra* note 107, at chs. 6–7 (citing the FDIC's 1984 Annual Report).

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A. Decreased On-Site Examination Hours

The answer to the first question can be found in the FDIC Office of Inspector General's (OIG) March 2005 audit of the Division of Supervision and Consumer Protection (DSC), the FDIC division responsible for examining financial institutions.¹¹⁶ In 2002, the DSC established an internal objective of reducing the average number of hours spent examining banks that qualified for the twelve-month exemption by 20%.¹¹⁷ By 2004, the DSC had not only achieved this objective but had also managed to cut examination hours by almost 30%.¹¹⁸ Encouraged by the initial success of this program, the FDIC mandated a further 10–20% reduction in examination hours in 2004 and required a field office to explain any failure to make an adequate cut in examination hours.¹¹⁹

The DSC has achieved these savings in overall examination hours by reducing the number of loans reviewed per examination and the extent of its transaction testing.¹²⁰ This represents a shift away from the traditional format of a bank examination. Prior to 2002, bank examinations generally entailed a review of 36–50% of a bank's overall loans.¹²¹ After the DSC changed its examination guidelines in 2002, the average number of loans reviewed decreased to 21–25%.¹²²

There are two main problems with this program. First, although the effect that the program has had on the overall integrity of the examination process is still unknown, decreasing the thoroughness of examinations while simultaneously increasing the length of the examination cycle is a high-risk policy. Any reduction in total loans re-

116. OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REP. NO. 05-015, DSC'S PROCESS FOR TRACKING AND EVALUATING THE IMPACT OF THE MERIT GUIDELINES (2005), available at <http://www.fdicig.gov/reports05/05-015.pdf>. The FDIC, like many government agencies, has an Office of Inspector General. This independent unit of the agency is responsible for auditing, investigating, and reviewing the agency's programs and operations. See FDIC OIG, FDIC Office of Inspector General Home Page, <http://www.fdicig.gov/index.html> (last visited Nov. 30, 2006). One division of the agency that the OIG audits is the Division of Supervision and Consumer Protection (DSC). The DSC, which is responsible for supervising and monitoring regulated financial institutions, is the main division of the FDIC. See FDIC 2004 ANNUAL REPORT, *supra* note 24, at 123 (noting that DSC employees accounted for over half of FDIC employees).

117. See DSC'S PROCESS FOR TRACKING AND EVALUATING THE IMPACT OF THE MERIT GUIDELINES, *supra* note 116, at 6.

118. *Id.* at 7.

119. *Id.* at 6 (stating that an explanation is required if an examination exceeds the target hours by 10%).

120. *Id.*

121. *Id.* at 8.

122. *Id.*

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viewed brings with it the possibility that examiners will miss potential issues that could jeopardize the safety and soundness of a financial institution.¹²³ Indeed, the OIG made precisely this argument to the DSC in its draft report on the DSC's new examination program.¹²⁴ By simultaneously increasing the time between examinations, the chance for early detection of problems that do arise is diminished. All financial institutions, even those that are well-run and well-capitalized, can experience bouts of financial instability. By changing its examination practices, the DSC has increased the possibility that formerly well-run banks can reach a point of imminent insolvency before the regulators are aware that problems exist.

Although the program appears to be limited to small banks,¹²⁵ any reduction in examination hours sets a dangerous precedent. For example, if Congress had expanded the twelve-month examination cycle exemption to all banks with under \$1 billion in assets by enacting H.R. 3505, the FDIC could have expanded its hour reduction program to any bank with under \$1 billion in assets. Furthermore, since this reduction in examination hours involves an internal policy, there is little evidence to suggest that the FDIC *has* limited its reduction in hours only to small banks.¹²⁶ As the only information available on

123. This argument applies equally as well with regards to transaction testing. During a compliance examination, the institution's policies and procedures for monitoring its compliance responsibilities are tested. See FED. DEPOSIT INS. CORP., COMPLIANCE EXAMINATION HANDBOOK II-4.7 (2006), available at <http://www.fdic.gov/regulations/compliance/handbook/compmanual.pdf>. The compliance examiner will then test a sample of transactions to verify accuracy and compliance. *Id.* at II-4.8. By scaling back the volume of transaction testing, examiner hours can be saved at the expense of an increased possibility of missing an existing problem.

124. DSC'S PROCESS FOR TRACKING AND EVALUATING THE IMPACT OF THE MERIT GUIDELINES, *supra* note 116, at 11–12. DSC disagreed with the draft report's "implication that the scaling back of loan portfolio reviews in the lowest-risk institutions represents a potential risk to the integrity of safety and soundness examinations." *Id.* at 12 (internal quotations omitted). The final OIG report uses conciliatory language when discussing DSC's new examination guidelines:

We revised the report to reflect that the reduction of loan coverage over long periods may or may not impact the levels of risk at the financial institutions rather than implying that, in fact, there was increased risk. It is our conclusion, however, that DSC could benefit from a monitoring process that specifically evaluates the outcome, in terms of risk, produced by the reduced loan penetration provided by MERIT examinations.

Id.

125. This assumption is based on the limited information made available by the FDIC's OIG. The only public reference to the FDIC's examination hour reduction program can be found in the OIG's 2005 audit. See DSC'S PROCESS FOR TRACKING AND EVALUATING THE IMPACT OF THE MERIT GUIDELINES, *supra* note 116, at 6.

126. Again, the only publicly available information on the FDIC's internal objectives appears in the OIG's audit report. See *id.*

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average examination hours involves the OIG's 2005 audit, it is currently unknown to what extent the DSC has mandated an across-the-board cut in hours.

Second, it is unclear whether the DSC's internal objectives are a cause or result of current staffing levels. On one hand, a reduction in examination hours could be the result of increasingly limited examination resources. With fewer total examiners, if the average number of hours spent on any individual examination were to remain fixed, the agency would eventually find itself unable to meet the statutorily dictated twelve-month examination cycle requirements. The internal objectives may therefore be driven by the agency's attempt to stretch its over-taxed examination resources such that each bank undergoes an examination, even if it is only a cursory one. On the other hand, it is equally plausible that a reduction in hours is motivated by factors completely unrelated to total examination staff, such as pressure from the banking industry to decrease government oversight. Under this scenario, the decrease in examination hours would be driven not by a need to conserve resources but for the purpose of creating a surplus in examination staff. Such a surplus could be used to justify further cuts in the examination workforce. In fact, this is exactly what the FDIC has done over the last three years.¹²⁷

B. Increased Regulatory Burden

Regardless of the actual reasons behind the decrease in examination hours, a reduction carries with it another unspoken cost. When a reduction in examination hours is driven not by an actual decrease in workload, but by goals set by the agency, examiners are placed in the unenviable position of being forced to choose what issues to focus on. Such a problem is exacerbated by the increased regulatory duties that Congress has placed upon the FDIC.

As noted, the bank regulatory agencies have promulgated over eight hundred regulations in the last fifteen years.¹²⁸ Much of the recent backlash against this "over-regulation" of the banking industry has focused on the effect that these regulations have had on the banks.¹²⁹ Yet, too often in the debate the toll that these regulations

127. See, e.g., FDIC 2004 ANNUAL REPORT, *supra* note 24, at 21, 122 (describing downsizing efforts).

128. See *supra* note 82 and accompanying text.

129. See *supra* notes 84-90 and accompanying text (discussing the burden money-laundering regulations have placed on banks). See, e.g., *Consideration of Regulatory Relief Proposals: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 109th Cong. (2005) (statement of Arthur R. Connelly, Member, Executive Committee of the Board of Directors, America's Community Bankers), available at <http://>

have taken on the agencies themselves in terms of examiner hours has been ignored. Over the last fifteen years, the FDIC has seen an increase in duties ranging from fairness in lending reporting requirements to the terrorist reporting requirements of the USA PATRIOT Act.¹³⁰

By far, the most frequently cited regulatory burden involves the reporting requirements of the Bank Secrecy Act (BSA).¹³¹ Under the BSA, a financial institution is required to file a Suspicious Activity Report whenever a financial transaction meets certain criteria. Driven by congressional focus on the “war on terror,” the banking industry has claimed that the agencies have been forced to adopt a zero-tolerance policy with regards to BSA compliance.¹³² The cost of this policy can be measured not only in the number of additional employees whom banks have been forced to hire in order to meet the strict reporting requirements but also in the number of hours that a DSC examiner must spend verifying that the bank is indeed in compliance. Although the FDIC does not normally provide information on average examina-

banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=163 (discussing the effect of regulations on community banks); *id.* (statement of John M. Reich, Vice Chairman, Federal Deposit Insurance Corporation) (focusing on the high costs of regulation on the banking industry).

130. *See, e.g.*, Home Mortgage Disclosure, 67 Fed. Reg. 7222 (Feb. 15, 2002) (increasing the types and amount of information required to be collected about mortgage applications); Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *Higher Priced Home Lending Data and the 2005 HMDA Data*, 2006 FED. RESERVE BULLETIN A123, A123 (2006), <http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf> (stating this change “substantially increase[d] the types and amount of information made available about home lending”); Financial Crimes Enforcement Network; Anti-Money Laundering Programs, 71 Fed. Reg. 496 (Jan. 4, 2006) (finalizing enhanced due diligence requirements for financial institutions under the USA PATRIOT Act of 2001, compliance with which must be monitored by an institution’s respective financial regulatory agency).

131. *See supra* notes 84–90 and accompanying text.

132. *See An Update on Money Services Businesses Under Bank Secrecy and USA PATRIOT Regulation: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 109th Cong. 3 (2005) (statement of Sen. Tim Johnson, Member, S. Comm. on Banking, Housing and Urban Affairs), *available at* <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=152> (stating that bankers are complaining of a zero-tolerance policy on BSA violations); *id.* at 67 (statement of John J. Byrne, Director, Center for Regulatory Compliance, American Banker Association) (referring to a zero-tolerance policy threatened by some bank examiners). These comments also acknowledge that the FDIC’s in-practice rules conflict with its official claims that it does not have any such policy. *See id.* at 6 (2005) (statement of Julie L. Williams, Acting Comptroller of the Currency) (“We absolutely do not have a ‘zero tolerance’ approach . . .”). *See also* Request for Burden Reduction Recommendations, 70 Fed. Reg. 5571 (Feb. 3, 2005); FDIC: FDIC Federal Register Citations, Comments: Request for Burden Reduction Recommendations, <http://www.fdic.gov/regulations/laws/federal/2005/05comegrpra.html> (last visited May 14, 2007).

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tion hours, let alone a categorical breakdown of how the hours are spent, anecdotal information from the banking industry indicates that examiners do not have enough time to engage in thorough reviews of BSA compliance.¹³³

The combination of an increase in examination duties and a decrease in total examination hours places examiners in an awkward position.¹³⁴ The examination staff may be forced to either: (1) perform a thorough examination by exceeding the hour cap imposed by the DSC and file an explanation of why he or she was unable to complete his or her job within the time allocated or (2) perform an inadequate examination and meet the hour target. Most would agree that an employee's performance, whether he or she works for the federal government or private industry, is commonly measured based on his or her ability to meet certain performance goals. There is no reason to believe that examiners are treated any differently. Therefore, it can be hypothesized that examiners have chosen to forgo thorough examinations in order to avoid the appearance that they are failing to meet impossible expectations. Nevertheless, without additional statistics or information, an outsider cannot adequately ascertain if this is indeed what has occurred.

C. *The FDIC's Impending Human Resource Crisis*

Whether reduced staffing levels have impacted the agency's ability to perform its regulatory duties can be measured in a third manner. Specifically, does the agency have the necessary resources to handle future financial crises? As noted below, the combination of current staffing levels and expected retirement suggests that it does not.

133. See FED. DEPOSIT INS. CORP., DSC RISK MANAGEMENT MANUAL OF EXAMINATION POLICIES § 8.1, <http://www.fdic.gov/regulations/safety/manual/> (last visited Mar. 1, 2007) (detailing the BSA-related policies, procedures, and records reviewed during an examination); EGRPRA.gov: Comprehensive Document – All Issues and Recommendations in Alpha Order – Derived From Banker Outreach Meetings, <http://www.egrpra.gov/outreachproposolAll.html> (last visited Mar. 1, 2007) (“Participants stated that the examination process for the Bank Secrecy Act has become too complex” and that “[n]ot only is compliance with BSA costly in terms of training, operating systems, and reporting, but nothing seems to be done with the data.”).

134. An examination team, under the guidance of an Examiner-in-Charge, generally performs the examination. A single bank examination normally includes a risk management examination and a variety of specialty examinations. See FED. DEPOSIT INS. CORP., DSC RISK MANAGEMENT MANUAL OF EXAMINATION POLICIES, *supra* note 133, at § 1.1-8 to -9.

Shortly after the beginning of 2005, total staff levels at the FDIC dipped below five thousand employees for the first time since 1984.¹³⁵ Staffing in the traditional Division of Supervision organization, which has decreased almost 50% since 1991, appears on track to dip below two thousand for the first time since 1984 as well.¹³⁶ Such a decrease in staffing appears to be a high-risk policy that directly conflicts with the agency's own analysis of the bank failures of the 1980s. Indeed, in its detailed report on the 1980s crises, the FDIC specifically stated that reducing examination staff to the levels seen in 1984 was an unnecessarily high-risk policy.¹³⁷ Yet, the current staffing situation at the FDIC is much worse than the one that existed in the early 1980s. Not only is the agency understaffed, but, like many government agencies, the FDIC faces an impending wave of baby-boomer retirements.¹³⁸

Across the entire government, it is expected that over half of all senior government managers will be eligible to retire before the end of the decade.¹³⁹ The situation with the FDIC is more severe. When the agency dramatically increased staffing in the 1980s, the agency almost tripled in size in less than four years.¹⁴⁰ After the wave of banking collapses subsided in the early 1990s, the agency effectively instituted a hiring freeze as it attempted to decrease the overall size of its workforce. As a result, the FDIC has not hired a significant number of new employees in over fifteen years, resulting in a workforce of relatively homogenous age.¹⁴¹ The agency estimates that within the next ten years it will replace or retrain over 100% of its current

135. See FED. DEPOSIT INS. CORP., STATISTICS AT A GLANCE: HISTORICAL TRENDS, *supra* note 113.

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136. As of 2004, the Division of Supervision had approximately 2005 employees. See FDIC 2004 ANNUAL REPORT, *supra* note 24, at 123; *supra* note 114 and accompanying text (discussing methodology for calculations).

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137. See HISTORY OF THE EIGHTIES, *supra* note 27, at 432.

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138. See NAT'L COMM'N ON THE PUB. SERV., URGENT BUSINESS FOR AMERICA: REVITALIZING THE FEDERAL GOVERNMENT FOR THE 21ST CENTURY 8 (2003), available at <http://www.uscourts.gov/newsroom/VolckerRpt.pdf>.

139. *Id.*

140. Total staff increased from 8060 in 1988 to 22,586 in 1991. See FED. DEPOSIT INS. CORP., STATISTICS AT A GLANCE: HISTORICAL TRENDS, *supra* note 113; MANAGING THE CRISIS, *supra* note 107, at ch. 11.

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141. The workforce is largely between the ages of 45 to 55 due to the fifteen-year hiring freeze, the agency's early retirement incentives, and the Federal Employees Retirement System minimum retirement ages of 55–57. See HISTORY OF THE EIGHTIES, *supra* note 27, at 426 (describing hiring freeze); OFFICE OF PERS. MGMT., RI 90-1, FEDERAL EMPLOYEES RETIREMENT SYSTEM: AN OVERVIEW OF YOUR BENEFITS 6 (1998), available at <http://www.opm.gov/forms/pdfimage/RI90-1.pdf>.

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workforce.¹⁴² This problem will be compounded by the fact that a large portion of the expected retirements will involve the agency's most experienced and knowledgeable employees.¹⁴³

As most of its staff retires, the FDIC will need to halt its hiring freeze and employee buyouts and begin to hire new employees. Much like in the 1980s, this process will involve diverting experienced examiners from actual examinations to employee training. Yet unlike during the financial crises of the 1980s, examiner attrition cannot be halted by simply changing hiring and retention policies. Examiners will be leaving the agency not as a result of normal attrition but due to age. If a financial crisis was to hit during this time, the agency will not have the necessary resources: to train new examiners, to continue to perform the routine examinations that are necessary in order to identify those institutions which face fiscal problems early on, and to handle increased duties related to closing and liquidating those banks that do fail. This impending wave of retirements, when combined with the current depressed level of agency staffing, raises serious questions as to the agency's ability to deal with any future financial crises. When the market experienced an unexpected downturn in the early 1980s, the agency found itself short-staffed due to the staffing reductions that it had undergone in the preceding years.¹⁴⁴ Although the FDIC immediately increased staffing in response to an increase in bank failures, these new examiners could not immediately be deployed to deal with the banking crises.¹⁴⁵ When the FDIC hires a new examiner, it takes approximately three to five years of training with experienced examiners before the new examiner becomes fully qualified.¹⁴⁶ During this time, the experienced examiners cannot

142. FDIC WORKFORCE 21 ACT OF 2004 (on file with The New York University Journal of Legislation and Public Policy). The agency expects this number to exceed 100% due to repeated turnover in any given position given the overall increased mobility in our nation's workforce. *Id.* The FDIC proposed the Workforce 21 Act to Congress in September 2004 for the purpose of granting the agency greater flexibility in managing its workforce. See OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REP. NO. 05-012, DIVISION OF SUPERVISION AND CONSUMER PROTECTION'S PROCESS FOR IDENTIFYING CURRENT AND FUTURE SKILL AND COMPETENCY REQUIREMENTS 18-19 (2005), available at <http://www.fdic.gov/reports05/05-012.pdf>. Although the FDIC and the FDIC Office of Inspector General still retain references to the proposed act on their website, the proposal itself and the agency's corresponding web pages were removed from the agency's website some time in 2006. See Internet Archive Wayback Machine, http://web.archive.org/web/*/www.fdic.gov/about/workforce_act/ (last visited June 8, 2007).

143. See FDIC WORKFORCE 21 ACT OF 2004, *supra* note 142.

144. See *supra* notes 50-52 and accompanying text.

145. See HISTORY OF THE EIGHTIES, *supra* note 27, at 426.

146. *Id.* at 427 n.19.

devote their complete attention to performing actual examinations as training demands consume an increased amount of their attention. Any reactionary hiring by the agency is therefore incapable of addressing a current financial crisis and can only serve to deal with future problems.

VI.

JUSTIFYING THE RISK

The FDIC does not believe that a human resources crisis is imminent. On the contrary, it believes that further staffing cuts may be warranted.¹⁴⁷ This view is rooted in the belief that the combination of fewer banks, increasingly sophisticated analytical tools, and a diversely trained workforce will enable the FDIC to adequately deal with any problems that may arise. Although it acknowledges a need to increase hiring sometime in the future, it does not believe that that time is now.¹⁴⁸

On November 1, 2005, Donald Powell stepped down after serving as Chairman of the FDIC for over four years. As part of his retirement announcement, the agency listed the “highlights” of his tenure.¹⁴⁹ The first highlight cited by the agency was the 27% decrease in authorized staffing under Chairman Powell’s tenure.¹⁵⁰ This is indicative of the agency’s current view of FDIC staffing.

To support its decrease in staffing and endorsement of the expansion of the eighteen-month examination cycle, the FDIC has presented four arguments. First, the agency claims that staffing reductions are necessary in order to reduce costs.¹⁵¹ Second, the agency claims that a reduction in the total number of banks has resulted in a decreased

147. Memorandum from Steven O. App, Deputy to the Chairman and CFO, to the Board of Directors (Nov. 23, 2005) (“[S]mall reductions-in-force are expected to be necessary in several organizations during 2006 to address remaining employee surpluses.”), *available at* <http://www.fdic.gov/news/board/05dec5budget.pdf>. The proposed 2006 budget further decreases currently authorized staff levels from 4751 to 4594 by year-end 2006. *Id.* Although there is no change in authorized field examiners, 120 DSC positions will be transferred as part of the agency’s internal training. *Id.*

148. *See* FDIC WORKFORCE 21 ACT OF 2004, *supra* note 142 (claiming that term appointments and selective hiring of experts and consultants will meet the agency’s specific skill needs).

149. FDIC, FDIC Accomplishments under Chairman Powell: 2001–2005, <http://www.fdic.gov/about/learn/board/powellAccomplishments.html> (last visited Mar. 1, 2007).

150. *Id.*

151. *See* FDIC 2004 ANNUAL REPORT, *supra* note 24, at 19 (highlighting the agency’s “rigorous planning and budgeting” in conjunction with staffing reductions).

workload for the examination staff.¹⁵² Third, the FDIC believes that new examination systems and techniques have reduced the need for regular, routine on-site examination.¹⁵³ Finally, the agency believes that in the event of a crisis, it will be able to rehire large numbers of former employees.¹⁵⁴

The argument for cost reduction is overstated and lacks a financial basis. Unlike most government agencies, the FDIC receives no congressional appropriations. Rather, the agency receives its funding almost exclusively through the premiums insured institutions pay into the Deposit Insurance Fund (DIF), which succeeded the Bank Insurance Fund (BIF).¹⁵⁵ The FDIC sets financial institution premiums at levels sufficient to ensure that the DIF maintains a funding level of at least 1.15% of total insured deposits.¹⁵⁶ As of September 30, 2004, the BIF reserve ratio exceeded the statutorily mandated level by 0.07%.¹⁵⁷ In fact, the BIF was so awash in cash that the FDIC has provided 90% of its insured institutions with a complete waiver of insurance premiums.¹⁵⁸ Although the reserve ratio of the DIF fell to 1.22% in 2006,¹⁵⁹ this decrease came after the FDIC granted wide-

152. See OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REP. NO. 05-012, DIVISION OF SUPERVISION AND CONSUMER PROTECTION'S PROCESS FOR IDENTIFYING CURRENT AND FUTURE SKILL AND COMPETENCY REQUIREMENTS 9 (2005), available at <http://www.fdicog.gov/reports05/05-012.pdf> (citing reduced volume of examinations due to industry consolidation as a factor in determining DSC staffing levels).

153. See *infra* note 166 and accompanying text.

154. See *infra* notes 174–77 and accompanying text.

155. See FDIC 2006 ANNUAL REPORT, *supra* note 114, at 33; FDIC: WHO IS THE FDIC?, *supra* note 11.

156. This requirement is mandated by the Federal Deposit Insurance Reform Act of 2005. Pub. L. No. 109-171, § 2105, 120 Stat. 9, 14–15 (2006). Before the Reform Act was enacted, the designated reserve ratio was statutorily fixed at 1.25%. See Deposit Insurance Funds Act of 1996, § 2704, Pub. L. No. 104-208, 110 Stat. 3009-479, 488 (1996). The Reform Act delegated authority to the FDIC to annually set a reserve ratio between 1.15% and 1.50%. Pub. L. No. 109-171, § 2105. The FDIC has not yet chosen to use this authority to alter the reserve ratio. See Deposit Insurance Assessments—Designated Reserve Ratio, 71 Fed. Reg. 69,323, 69,325 (Nov. 30, 2006) (to be codified at 12 U.S.C. § 1817(b)(3)(A)) (holding the reserve ratio at 1.25%). Many individuals might be surprised to discover that the DIF only holds enough reserves to handle a loss of 1.25% of industry-wide insured assets. Losses exceeding this amount will bankrupt the fund. As of September 30, 2006, the DIF was under-funded by 0.03%, at 1.22%. See FDIC 2006 ANNUAL REPORT, *supra* note 114, at 32.

157. See FDIC 2004 ANNUAL REPORT, *supra* note 24, at 55 (reporting a reserve ratio of 1.32%). The required reserve ratio in 2004 was 1.25%. See *supra* note 156.

158. See FDIC 2005 ANNUAL REPORT, *supra* note 111, at 27 (reporting an assessment rate of 0 for over 90% of insured institutions).

159. See FDIC 2006 ANNUAL REPORT, *supra* note 114, at 32.

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spread waivers of premium payments.¹⁶⁰ Furthermore, since 2002, the FDIC's spending has decreased significantly as a percentage of its operating base.¹⁶¹ Put simply, the FDIC has plenty of cash available. Further cost-reduction strategies should be carefully analyzed, since they are arguably unnecessary.

The second argument—that industry consolidation has resulted in a decreased examination workload—rests on the assumption that the decrease in total examinations more than compensates for the increased complexity of each individual examination. Granted, the total number of insured institutions has decreased almost 50% since 1990.¹⁶² Nevertheless, with the ever-progressing sophistication of financial structures and transactions, bank supervision is an increasingly complex responsibility.¹⁶³ The FDIC has cited increased bank size, globalization, evolving technology, internet banking, securitization of risk, expanded credit card banking, and sub-prime lending as new and increasingly difficult challenges for banking supervision.¹⁶⁴ Given the breadth and complexity of these issues, it seems dubious for the FDIC to claim that the decrease in the total number of banks offsets the increased examination workload. In fact, as discussed below, the

160. See FDIC 2004 ANNUAL REPORT, *supra* note 24, at 27 (reporting an assessment rate of 0 for over 90% of insured institutions); FDIC 2005 ANNUAL REPORT, *supra* note 111, at 27 (same); FDIC 2006 ANNUAL REPORT, *supra* note 114, at 14 (indicating waiver now applies to 95.1% of all insured institutions).

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161. See FDIC 2006 ANNUAL REPORT, *supra* note 114, at 33–34 (touting the agency's decreasing expenses). The agency's expenses also continue to come in under budget. For example, in fiscal year 2004, the FDIC budgeted for \$1.210 billion in expenditures, while actual expenditures for the year totaled only \$1.112 billion, \$98 million less than originally projected. FDIC 2004 ANNUAL REPORT, *supra* note 24, at 30. See also FDIC 2006 ANNUAL REPORT, *supra* note 114, at 38 (reporting actual expenditures for fiscal year 2006 as \$77 million less than budgeted).

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162. See FED. DEPOSIT INS. CORP., STATISTICS AT A GLANCE: HISTORICAL TRENDS, *supra* note 113.

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163. GOV'T ACCOUNTABILITY OFFICE, GAO-07-255, FEDERAL DEPOSIT INSURANCE CORPORATION: HUMAN CAPITAL AND RISK ASSESSMENT PROGRAMS APPEAR SOUND, BUT EVALUATIONS OF THEIR EFFECTIVENESS SHOULD BE IMPROVED 1 (2007).

164. *Alternative Personnel Systems: Assessing Progress in the Federal Government: Hearing Before the Subcomm. on Oversight of Gov't Mgmt., the Fed. Workforce and the District of Columbia of the S. Comm. on Homeland Sec. and Governmental Affairs*, 109th Cong. (2005) (statement of Arleas Upton Kea, Director, Division of Administration, Federal Deposit Insurance Corporation), available at <http://www.senate.gov/~govt-aff/index.cfm?Fuseaction=Hearings.Detail&HearingID=279> ("Moreover, globalization, evolving technology, privacy concerns and increased use of nontraditional banking business lines, such as Internet banking, securitization, expanded credit card banking, and sub-prime lending, pose new, and potentially much greater, challenges for the FDIC.").

FDIC has admitted that current staffing levels are insufficient to handle the failure of even a single large bank, let alone more than one.¹⁶⁵

The third argument put forward in support of the FDIC's decrease in staffing is that new examination systems and techniques have reduced the need for regular, routine on-site examinations.¹⁶⁶ For example, the DSC's MERIT examination guidelines involve a decrease in overall loan penetration ratios, which is achieved through the increased use of off-site monitoring programs.¹⁶⁷ Examiners-in-charge further determine the scope of examinations based partially on the off-site examination data. These claims ignore both the lessons of the past and fundamental human nature. Although the FDIC may believe that sophisticated risk assessment models and comprehensive data will alleviate the need for on-site monitoring, such arguments have been made before—specifically by the FDIC just prior to the banking crises of the 1980s.¹⁶⁸

Banks collapse largely because of bank runs, human error, or excessive corporate risk-taking, which results in losses exceeding the bank's available assets.¹⁶⁹ Basically, bank executives either embezzle funds or make a series of bad loans, the extent of which they may try to hide from the FDIC. Furthermore, the claim that the decrease in community or small bank assets relative to the larger institutional banks justifies a decrease in on-site monitoring has also been made in

165. *Id.* ("The failure of one or more large banks will require trained resolution and liquidation specialists in numbers far larger than is economically feasible to maintain on a standby basis.").

166. See FDIC 2004 ANNUAL REPORT, *supra* note 24, at 36 (describing the significant progress made in off-site risk identification models); *Financial Services Regulatory Relief: The Regulators' Views: Hearing Before the Subcomm. on Fin. Instits. and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 16 (2005) (statement of Randall S. James, Comm'r, Texas Department of Banking) ("[W]e believe that advances in off-site monitoring techniques and technology and the health of the banking industry make annual on-site examinations unnecessary for the vast majority of the healthy financial institutions we have.").

167. See DSC'S PROCESS FOR TRACKING AND EVALUATING THE IMPACT OF THE MERIT GUIDELINES, *supra* note 116, at 1–9. On March 31, 2002, the DSC adopted the Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) guidelines for safety and soundness examinations. *Id.* at 1–2. If the FDIC determines a bank qualifies for examinations under the MERIT guidelines, examiners will conduct an abridged examination. See *id.* at 2–3. This limited risk-focused examination selects a more limited number of loans for evaluation based on the risk profile of the bank. *Id.* at 8. For a list of criteria used to determine if a bank qualifies for the use of the MERIT guidelines, see *id.* at 16–18.

168. See HISTORY OF THE EIGHTIES, *supra* note 27, at 422–23.

169. See *supra* notes 14–17 and accompanying text.

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the past—by the OCC in 1982,¹⁷⁰ shortly before its banks caused 73% of total DIF losses.¹⁷¹

Finally, banks generate revenue through the spread between the interest rates that they charge borrowers and the interest rates that they must pay depositors.¹⁷² By increasing this spread, banks increase their total revenue. Bank examiners serve as agents of the depositors, ensuring that a bank is not taking excessive risks with the depositors' money. If examiners rely too heavily on off-site monitoring, bank managers may be tempted to engage in riskier lending under the belief that such loans will either go unnoticed or be repaid before examiners next come around. This aspect of human nature underlies the FDIC's prior findings that on-site examinations are critical for ensuring the integrity of a bank's financial reporting.

In the end, the FDIC admits that due to its downsizing, it does not have the resources necessary to handle the collapse of even one major bank.¹⁷³ Nevertheless, the agency believes that it has developed a plan to deal with such a catastrophe, which reads like the script of *Space Cowboys*:¹⁷⁴ it will rehire a large number of its former employees by enticing them out of retirement.¹⁷⁵ That the FDIC's plan for dealing with the collapse of a single major bank involves the assumption that it can lure former employees out of retirement seems quite unrealistic. Although some number of agency employees might choose to return out of a sense of duty or economic self-interest, it seems reasonable to assume that most retirees will not be willing to upend their retirement plans for the good of the agency. The agency, though, believes that this plan will work, assuming that it is granted the ability to waive certain government-mandated compensation restrictions in order to attract its former employees. Furthermore, the

170. See HISTORY OF THE EIGHTIES, *supra* note 27, at 424 n.11.

171. See KHADEMIAN, *supra* note 59, at 7.

172. Net interest income derived from a bank's interest rate spread is an important income source for deposit institutions, particularly community banks. See Allen Puwalski, *Increasing Interest Rate at Community Banks and Thrifts*, BANK TRENDS, (Fed. Deposit Ins. Corp., D.C.), May 2000, at 1, http://www.fdic.gov/bank/analytical/bank/bt_0001.pdf.

173. See FDIC WORKFORCE 21 ACT OF 2004, *supra* note 142 (“[The skills necessary to deal with a banking crisis] are acquired over several years, making it impossible to hire and train new staff to respond to a major crisis.”).

174. SPACE COWBOYS, starring Clint Eastwood, Tommy Lee Jones, Donald Sutherland, and James Garner, involved a race against time to fix a satellite before it crashed into earth. The only individuals who knew how to fix the satellite were four former test pilots forty years past their prime. SPACE COWBOYS (Warner Bros. 2000).

175. See FDIC WORKFORCE 21 ACT OF 2004, *supra* note 142 (“Tools are needed to allow the quick but temporary rehiring of large numbers of such specialists who have retired from the FDIC and who possess the necessary skills.”).

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agency claims that it has been forced to adopt this contingency plan because it is not economically feasible to maintain an adequate number of specialists.¹⁷⁶ As has already been addressed, this is an assumption based on budgetary constraints that appear to have no correlation with the agency's underlying fiscal picture.¹⁷⁷

VII.

CONCLUSION

Available evidence suggests that over the last few years, the FDIC's ability to handle a banking crisis has been seriously eroded. Four factors support this contention. First, there has been a decrease in the average time spent performing on-site examination. Second, examiners have simultaneously incurred an increase in their overall duties. Third, the total number of bank examiners has decreased significantly. Finally, a large number of the remaining experienced examiners are expected to retire in the next ten years. The stage has once again been set for a dramatic banking crisis.

Congress has the opportunity to minimize the risk to the financial industry. Although Congress properly declined to reauthorize agency discretion in the area of examination cycle length, the regulatory agencies' tendencies towards reduced oversight needs to be reigned in. The small bank exceptions passed throughout the last decade should be repealed and minimum standards should be developed for institution examinations. Likewise, Congress needs to consider whether the money laundering provisions that it has enacted are justified considering the stress that they have placed on the agencies. Congress's passage of a more limited bill that focused on providing relief from the money-laundering laws it enacted as part of the wars on drugs and terrorism represents an admirable first step.

Furthermore, the FDIC need not continue to decrease its workforce. Even with widespread insurance premium exemptions, the DIF had been fully capitalized for over five years. Although the reserve ratio has dipped below the statutorily-required reserve ratio, if these exemptions are repealed, the agency will be flush with cash. Given the agency's fiscal health, decreasing the examination force in order to save tens of millions of dollars is not justified. The agency applied such policies in the 1980s, with disastrous results. The lessons of the past are clear—cutting examination staff and increasing the examination cycle are unnecessary risks.

176. *See id.*

177. *See supra* notes 155–61 and accompanying text.