

## I. INTRODUCTION

Section 38 of the Federal Deposit Insurance (FDI) Act, 12 U.S.C. 1831o, Prompt Corrective Action (PCA), restricts or prohibits certain activities for all insured depository institutions (IDIs) and establishes a framework of supervisory actions for IDIs that are not Adequately Capitalized. The restrictions and prohibitions become more severe as an institution's capital category declines. The purpose of Section 38 is to resolve the problems of IDIs at the least possible long-term loss to the Deposit Insurance Fund (DIF). Section 38 also requires Undercapitalized IDIs to submit a capital restoration plan to the appropriate federal banking agency.

Part 303, Subpart K, and Part 390, Subpart F of the FDIC Rules and Regulations implement Section 38 of the FDI Act. Section 303.200(a)(1) requires IDIs that are not Adequately Capitalized to obtain regulatory approval prior to engaging in certain activities.

Definitions of the capital categories referenced in Part 303, Subpart K of the FDIC Rules and Regulations are located in the following sections of the FDIC Rules and Regulations: Section 324.403(b) for state nonmember banks and Section 324.403(c) for insured branches of foreign banks. Definitions of the capital categories for state savings associations related to the referenced sections of Part 390, Subpart F of the FDIC Rules and Regulations are also located in Section 324.403(b).

Restrictions and prohibitions are addressed in the PCA section of Part 324, Subpart H (e.g., Section 324.405) of the FDIC Rules and Regulations, which applies primarily to insured state nonmember banks, state savings associations, and insured branches of foreign banks, as well as to directors and senior executive officers of those institutions.

The purpose of this Section of these Procedures is to describe the restrictions (and possible exceptions to those restrictions) contained in the FDIC's regulations; the related application process; and capital restoration plans. There are other restrictions included in the referenced regulations, which Case Managers should review.

**Note:** Refer to Part 324, Subpart H for PCA rules applicable to state nonmember banks, state savings associations, and insured branches of foreign banks. The Regional Office (RO) Capital Markets Specialist may provide assistance in interpreting these standards. RO staff should also consult with Washington Office (WO) staff (Risk Management and Applications Section (RMAS) and Legal), as needed, regarding these standards. Related application and enforcement rules and regulations for state nonmember banks and insured branches of foreign banks are found in Parts 303 and 308 of the FDIC Rules and Regulations and for state savings associations in Part 390. Parts 303 and 308 are expected to be revised to include references to state savings associations.

## II. FORM OF APPLICATION

Five types of applications are described in Part 303, Subpart K of the FDIC Rules and Regulations. These include (1) capital distributions; (2) acquisitions, branching, and new business lines; (3) bonuses and increased compensation for senior executive officers; (4) payment of principal or interest on subordinated debt; and (5) engaging in restricted activities for Critically Undercapitalized institutions. The filing requirements for each type of application are discussed below.

Pursuant to Section 303.201 of the FDIC Rules and Regulations, applicants will submit either a letter application or an electronic application via the secure information exchange system to the

appropriate RO. Refer to *Applications Overview*, Section 1.1 of these Procedures, for further information regarding applications filed through the FDIC's secure information exchange system. Case managers should ensure that filings address the information specific to the type of application. The letter should be signed by the president, senior officer, or a duly authorized agent of the IDI and be accompanied by a certified copy of a resolution adopted by the institution's board of directors or trustees authorizing the application. Additional information may be requested by the FDIC.

#### Capital Distributions (§303.203) and (§390.345)

Any insured state nonmember bank, state savings association, or insured branch of a foreign bank must submit an application for a capital distribution if, after having made a capital distribution, the institution would be Undercapitalized, Significantly Undercapitalized, or Critically Undercapitalized. Regarding applications for a capital distribution under any of the cited PCA categories, state savings associations will be processed pursuant to Part 390, Subpart F. Case Managers are to ensure that an application to repurchase, redeem, retire, or otherwise acquire shares or ownership interests of the IDI<sup>1</sup>:

- Describes the proposal;
- Describes the shares or obligations that are the subject thereof;
- Describes the additional shares or obligations of the institution that will be issued in at least an amount equivalent to the distribution; and
- Explains how the proposal will reduce the institution's financial obligations or otherwise improve its financial condition.

If the proposed action also requires an application under Section 18(i) of the FDI Act, as implemented by Sections 303.241 and 390.345 of the FDIC Rules and Regulations regarding prior consent to retire capital, the application should be filed concurrently with, or made part of, the application filed pursuant to Section 38 of the FDI Act. See also *Reduce or Retire Capital*, Section 14 of these Procedures.

#### Acquisitions, Branching, and New Business Lines (§303.204) and (§390.100)

Any insured state nonmember bank, state savings association, or any insured branch of a foreign bank that is Undercapitalized or Significantly Undercapitalized, and any IDI that is Critically Undercapitalized, must submit an application to engage in acquisitions, branching, or new lines of business. (The authority addressing such applications involving state savings associations is Part 390, Subpart F (Application Processing Procedures)). A new line of business includes any new activity which, although permissible, has not been exercised previously by the institution. Case Managers are to ensure that the application<sup>2</sup>:

- Describes the proposal;
- States the date the institution's capital restoration plan was accepted by its primary federal regulator (PFR);
- Describes the institution's progress toward implementing the capital restoration plan;
- Explains how the proposed action is consistent with and will further the achievement of the capital restoration plan, or otherwise furthers the purposes of Section 38 of the FDI Act;

<sup>1</sup> Information necessary for a capital distribution application for SSAs is contained in Section 390.346.

<sup>2</sup> The requirements contained in Section 303.204 do not apply to SSAs, except for SSAs that are in the critically undercapitalized category. For applications by SSAs under Subpart F of Part 390, sections 390.105 and 390.106 address information required for acquisitions, branching, and new business lines.

and,

- States whether approval has been requested from the applicant's PFR, the date of such request, and the disposition of such request, if the FDIC is not the applicant's PFR and these requests are applicable.

If the proposed action also requires applications pursuant to Section 18(c) or (d) of the FDI Act (mergers and branches), Section 24 of the FDI Act (insured state bank activities), Section 28 of the FDI Act (state savings association activities), or Section 5 of the Home Owners Loan Act (HOLA) (exemption from certain sanctions regarding capital standards), such applications should be filed concurrently with, or made a part of, the application filed pursuant to Section 38 of the FDI Act.

#### Bonuses and Increased Compensation for Senior Executive Officers (§303.205) and (§390.100)

Any insured state nonmember bank, state savings association, or insured branch of a foreign bank that is Significantly or Critically Undercapitalized, or any insured state nonmember bank, state savings association, or insured branch of a foreign bank that is Undercapitalized and has failed to submit or implement, in any material respect, an acceptable capital restoration plan, must submit an application to pay a bonus or increase compensation for any senior executive officer<sup>3</sup>.

Case Managers are to ensure the application:

- Lists each proposed bonus or increase in compensation and, for the latter, identifies compensation for each of the 12 calendar months preceding the calendar month in which the institution became Undercapitalized;
- States the date the institution's capital restoration plan was accepted by the FDIC; and
- Describes any progress made in implementing the capital restoration plan.

#### Payment of Principal or Interest on Subordinated Debt (§303.206)

Any Critically Undercapitalized IDI, regardless of charter, must submit an application to pay principal or interest on subordinated debt. Case Managers are to ensure the application:

- Describes the proposed payment;
- Provides an explanation of action taken under Section 38(h)(3)(A)(ii) of the FDI Act (action other than receivership or conservatorship); and
- Explains how such payments would further the purposes of Section 38 of the FDI Act.

Existing approvals pursuant to requests filed under Section 18(i)(1) of the FDI Act (e.g., capital-stock reductions or retirements) should not be deemed to be the permission needed pursuant to Section 38 of the FDI Act.

#### Restricted Activities for Critically Undercapitalized Institutions (§303.207)

Any Critically Undercapitalized IDI, regardless of charter, shall submit an application to engage in certain restricted activities.

Case Managers are to ensure that applications to engage in activities set forth in Sections 38(i)(2)(A) through (G) of the FDI Act and Section 303.207 of the FDIC Rules and Regulations,

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<sup>3</sup> The authority for such applications involving state savings associations is Part 390, Subpart F. Both sections 390.105 and 390.106 address the information required for such applications.

describe the proposed activity and explain how the activity would further the purposes of Section 38 of the FDI Act. These activities are described below.

- Enter into any material transaction other than in the usual course of business, including any action with respect to which the institution is required to provide notice to the appropriate federal banking agency. Materiality will be determined on a case-by-case basis;
- Extend credit for any highly leveraged transaction (as defined in Section 303.207(b)(2) of the FDIC Rules and Regulations);
- Amend the institution's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order;
- Make any material change in accounting methods;
- Engage in any covered transaction (as defined in Section 23A(b) of the Federal Reserve Act);
- Pay excessive compensation or bonuses. (Part 364 of the FDIC Rules and Regulations implements Section 39 of the FDI Act and provides the regulatory framework for safety and soundness principles. Appendix A to Part 364 provides guidance for determining excessive compensation. The FDIC will consider the current compensation of an institution's executive officers, directors, and principal shareholders on a case-by-case basis and will require prior written approval for any proposed change in their compensation levels, if such levels are determined to be excessive (i.e., unreasonable and disproportionate to the services provided or likely to result in a material financial loss to the institution); or
- Pay interest on new or renewed liabilities at a rate that would increase the institution's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest on insured deposits in the institution's normal market area. Section 337.6 of the FDIC Rules and Regulations provides guidance for defining the relevant terms of this provision; however, this provision does not supersede the general prohibitions contained in Section 337.6<sup>4</sup>.

### III. ACCEPTING AND PROCESSING THE APPLICATION

Case Managers are to process applications described in this Section following the steps below, as well as the instructions contained in *Applications Overview*, Section 1.1 of these Procedures<sup>5</sup> that pertain to all application types. Additional information is located in Part 303, Subpart K and in Part 390, Subpart F of the FDIC Rules and Regulations.

1. All applications should be entered into the appropriate internal database within three business days of receipt. In all cases, dates and comments in the record should be updated regularly to reflect the current status of the application.
2. An application should be reviewed upon receipt, or as close to receipt as possible, to determine whether it is substantially complete.
3. Although the Regional Director has delegated authority to act on these applications, such authority can only be exercised after consultation with the WO on all relevant issues. Depending on the specific circumstances, the WO may determine that authority should be

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<sup>4</sup> On September 4, 2019, the FDIC published a proposal to update the rate restrictions applicable to less than well-capitalized institutions. When finalized, this rulemaking will move rate restrictions from section 337.6 to 337.7.

<sup>5</sup> Case Managers are to follow the general instructions and expectations for all applications regarding receipt and acceptance, recordkeeping responsibilities, DCP notifications, WO action or input, delegations, etc., in *Applications Overview*, Section 1.1 of these Procedures.

exercised at the WO level. Therefore, the RO should consult with the WO RMAS before accepting the application. If the WO decides to act on the application, advise the applicant that the application will be forwarded to the WO for action.

4. Provide a copy of the application materials to RO Legal to determine whether there are any legal issues that should be considered.
5. Thoroughly analyze the application and any supporting exhibits and materials. As necessary, communicate any follow-up questions, issues, and/or information needs to the applicant. Any other applications that were filed concurrently with the PCA application should be processed concurrently, pursuant to the procedures and processing timeframes applicable for those filings.
6. Complete the appropriate Summary of Investigation (SOI) form.<sup>6</sup> The SOI Comments should:
  - Describe the proposed action requiring the application;
  - Identify the applicant's PCA capital category;
  - Describe the institution's financial condition;
  - Discuss the status of and compliance with the institution's capital restoration plan;
  - Evaluate the effect of the proposal on the institution's condition;
  - Include an analysis of, with a conclusion of favorable/unfavorable for, the applicable requirements in Section 38 of the FDI Act and Part 303, Subpart K or Part 390, Subpart F of the FDIC Rules and Regulations;
  - Consider whether changes to the application or appropriate non-standard conditions should be sought prior to approving an application;
  - Discuss the attitude of the state authority and, if applicable, the PFR;
  - Discuss the applicant's compliance with BSA/AML as needed;
  - Identify the applicant or bank representative, including name, title, mailing address, telephone number, and e-mail address; and
  - Include the recommended action.

Retrieve the Application Summary Statement from the system of record and attach it to the SOI.

7. If approval is being recommended, prepare an approval letter, which should include the standard conditions set forth in Section 303.2(dd) of the FDIC Rules and Regulations, as well as any non-standard conditions deemed necessary. The Case Manager should obtain the applicant's written commitment to adhere to the non-standard conditions prior to submitting the approval documents for signature. Refer to *Standard and Non-standard Conditions*, Section 1.11 of these Procedures, for further instruction. If the RO has delegated authority, issue the approval letter to the applicant, with copies to the appropriate regulatory agencies.
8. If consideration of the application may result in a denial, the RO should advise the applicant of the problem areas to ensure that all relevant facts are obtained prior to making a decision. Refer to *Denials and Disapprovals*, Section 1.3 of these Procedures, for additional information.
9. If the application is denied, the letter should state the reasons for the denial. If the RO has delegated authority, issue the denial letter to the applicant, with copies to the appropriate

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<sup>6</sup> Case Managers are to follow the instructions and SOI requirements for all types of filings found in *Summary of Investigation*, Section 1.2 of these Procedures, as well as the specific instructions in this Section.

regulatory agencies.

10. For applications that cannot be acted on in the RO, forward the SOI, the draft letter, and all relevant documentation to the WO for final action. Documentation for applications requiring WO approval or denial should be more comprehensive and should describe the reasons why action cannot be taken by the Regional Director. Refer to *Applications Overview*, Section 1.1 of these Procedures, for additional instructions regarding applications that require WO action or input.
11. Update the appropriate internal database to reflect the date forwarded to the WO, if applicable, the final action, the date of the action, expiration date, hours spent processing the application, and any other required information.

#### IV. CAPITAL RESTORATION PLANS

Pursuant to Section 324.404 of the FDIC Rules and Regulations, an FDIC-supervised institution must file a written capital restoration plan (Plan) with the appropriate FDIC Regional Director within 45 days of the date that the institution receives notice or is deemed to have notice that the institution is Undercapitalized, Significantly Undercapitalized, or Critically Undercapitalized, unless the FDIC notifies the institution in writing that the plan is to be filed within a different period. Undercapitalized institutions that fail to submit a written Plan within 45 days, or subsequently fail to implement a Plan, are subject to the restrictions applicable to Significantly Undercapitalized institutions. Under Section 324.402 and 324.403(d) of the FDIC Rules and Regulations, an IDI is deemed to have been notified of its capital level and its capital category as of the most recent date:

- A Call Report is required to be filed with the FDIC;
- A final report of examination is delivered to the FDIC-supervised institution;
- Written notice is provided by the FDIC to the FDIC-supervised institution of its capital category for purposes of Section 38 of the FDI Act; or
- The FDIC-supervised institution's capital category has been reclassified based upon supervisory criteria other than capital, as provided in Section 324.403(d) of the FDIC Rules and Regulations.

An Adequately Capitalized institution that has been reclassified pursuant to Sections 324.403(d) of the FDIC Rules and Regulations as Undercapitalized is not required to submit a Plan solely by virtue of the reclassification.

Section 38(e)(2)(C)(ii) of the FDI Act provides that the appropriate federal banking agency shall not accept a Plan unless each company that controls the institution has: (1) guaranteed that the institution will comply with the Plan until the institution has been Adequately Capitalized on average during each of four consecutive calendar quarters; and (2) provided appropriate assurances of performance. See Section 324.404(h) of the FDIC Rules and Regulations.

*Note: Records are not required for capital restoration plans.*

#### Filing a Capital Restoration Plan

Case Managers are to ensure that plans filed under Section 324.404 of the FDIC Rules and Regulations include all of the information required to be filed under Section 38(e)(2)(B) of the FDI Act, 12 U.S.C. 1831o(e)(2)(B), which requires the Plan to specify:

- The steps the institution will take to become at least Adequately Capitalized;
- The levels of capital to be attained during each year in which the Plan will be in effect;
- How the institution will comply with the restrictions or requirements in effect under Section 38;
- The types and levels of activities in which the institution will engage; and
- Other such information as the appropriate federal banking agency may require.

All financial data submitted in connection with a Plan shall be prepared in accordance with the instructions provided in the Call Report, unless the FDIC instructs otherwise. An FDIC-supervised institution that is required to submit a Plan as a result of its reclassification pursuant to Sections 324.402(c) or 324.403(d) of the FDIC Rules and Regulations shall include a description of the steps the institution will take to correct the unsafe or unsound condition or practice.

#### Criteria for Accepting the Capital Restoration Plan

The FDIC may not accept a Plan unless the FDIC determines that:

- The Plan includes all the requirements set forth in Section 38(e)(2)(B) of the FDI Act;
- The Plan is based on realistic assumptions and is likely to succeed in restoring the institution's capital;
- The Plan would not appreciably increase the risk (e.g., credit risk, interest-rate risk, and other types of risk) to which the institution is exposed; and
- Each company having control of the institution has guaranteed that the institution will comply with the Plan until the institution has been at least Adequately Capitalized, on average, during each of the four consecutive calendar quarters and has provided appropriate assurances of performance.

#### Processing Capital Restoration Plans

1. Review the Plan promptly to determine whether all information and other elements required by regulation have been submitted. There may be circumstances where the Regional Director grants an opportunity for an institution to revise an inadequate Plan or provide additional information. In such cases, a letter should be sent to the institution that specifies the weaknesses and establishes a specific due date for submission of a revised Plan or additional information. The Regional Director may inform the institution that parts of the Plan are acceptable and should be implemented while the remainder of the Plan is still under consideration; however, approving partial implementation of a Plan is uncommon, since only significant shortcomings are expected to preclude approval of a Plan. Plans should generally:
  - Reflect a return to at least Adequately Capitalized within a reasonable time period;
  - Contain reasonable and supported financial projections, including pro-forma statements and an explanation of any assumptions used (e.g., interest rate projections and growth rates);
  - Contain interim target capital levels to facilitate monitoring progress towards meeting the goals of the Plan; and
  - Include detailed information regarding any potential capital sources or injections that are included in the Plan.
2. The Case Manager should prepare a memorandum to the file that documents the analysis of the Plan. The memorandum should include an explicit discussion of each criterion established in Section 38(e)(2)(C) of the FDI Act for accepting a Plan and provide sufficient data to support

the action taken on the Plan. The memorandum should also:

- Include an assessment of the feasibility of the Plan and, to the extent possible, a discussion of contingency sources for capital; and
  - Include an analysis of the effect of the Plan on the institution's risk profile, particularly in light of any planned sale of liquid assets, branch offices, or other asset dispositions.
3. The Case Manager should prepare and provide written notice to the institution advising of the approval or disapproval of the Plan. The letter should:
- Include language reminding the institution's directors of the restrictions to which the institution is subject under Section 38 of the FDI Act and Section 324.405 of the FDIC Rules and Regulations;
  - For an approval letter, indicate that approval of the Plan does not represent approval of any actions included in the Plan that are subject to prior regulatory approval or notification; and
  - For a disapproval letter, include the requirement to submit a revised Plan by a specific due date and, if the institution is Undercapitalized, indicate that upon receiving notice that its Plan has not been approved, the institution shall be subject to all of the restrictions applicable to Significantly Undercapitalized institutions until such time as a new or revised Plan has been approved by the FDIC.

#### Capital Restoration Plans Approved by Other Agencies

Section 38(e)(2)(D)(iii) of the FDI Act requires the other federal banking agencies to submit a copy of any Plan approved by the agency to the FDIC within 45 days from the date such approval is granted. The Case Manager should review plans immediately upon receipt. Any questions or concerns should be discussed with the PFR either verbally or through written correspondence. All verbal discussions should be documented in a memorandum to the file and should include the contact's name and position at the other agency. All written exchanges and memorandums to the file should be maintained in the appropriate internal database. Any unresolved questions or concerns should be raised to RO management and, as appropriate, to WO.

#### PCA Report and Capital Restoration Plan Periodic Review

The Case Manager should evaluate an institution's compliance with its approved Plan at least quarterly and document the review in the PCA Form, located in the PCA Report Section of the supervisory database.<sup>7</sup> The Case Manager should review the Plan, restrictions, and requirements applicable to any Undercapitalized institution at least quarterly to determine whether those measures are achieving the purpose of Section 38 of the FDI Act, or whether some other supervisory action may be more effective. The applicable review dates should be recorded in the PCA Form.

### **V. TIME FRAME FOR PROCESSING**

There are no statutory requirements regarding the review and processing of the applications discussed in this Section, except Plans. The FDIC will provide the applicant with a written notification of the final action taken as soon as the decision is rendered.

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<sup>7</sup> Institutions are automatically added to the database when capital is deemed to be at or below Adequately Capitalized levels.



Regarding the review and processing of Capital Restoration Plans, Section 38(e)(2)(D) of the FDI Act and Section 324.404 of the FDIC Rules and Regulations set forth the following:

1. An FDIC-supervised institution shall file a written Plan with the appropriate RO within 45 days of receiving notice or being deemed to have notice that the institution is Undercapitalized, Significantly Undercapitalized, or Critically Undercapitalized, unless the FDIC notifies the institution in writing that the Plan is to be filed within a different period;
2. Within 60 days after receiving a Plan, the FDIC shall provide written notice to the institution of whether the Plan has been approved. The FDIC may extend this timeframe; and
3. The PFR for non FDIC-supervised institutions shall submit to the RO a copy of any Plan approved by the PFR within 45 days of the approval date.

#### **VI. PUBLICATION REQUIREMENT**

None.

#### **VII. DELEGATED AUTHORITY**

FDIC RMS and RO delegations of authority regarding applications, notices, and other filings are discussed in *Applications Overview*, Section 1.1 of these Procedures.

#### **VIII. REFERENCES**

*Sections 38 and 18(i) of the FDI Act*

*Part 303, Subpart K; Part 324, Subpart H; and Part 390, Subpart F of the FDIC Rules and Regulations*

*Risk Management Manual of Examination Policies - Formal Administrative Actions - Capital Plans*