

Office of Inspector General



Office of Audits
Report No. AUD-11-011

**In-Depth Review of the Failure of
USA Bank, Port Chester, New York**

July 2011



Why We Did The Audit

On July 9, 2010, the New York State Banking Department (NYSBD) closed USA Bank, and the FDIC was named as receiver. On July 29, 2010, the FDIC notified the Office of Inspector General (OIG) that USA Bank's total assets at closing were \$196.1 million and that the estimated loss to the Deposit Insurance Fund (DIF) was \$60.8 million. As of April 30, 2011, the estimated loss to the DIF had increased to \$65.2 million.

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act). The Financial Reform Act amends section 38(k) of the Federal Deposit Insurance Act (the FDI Act) by increasing the material loss review (MLR) threshold from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Although the estimated loss for USA Bank does not meet the amended threshold requiring an MLR, the OIG determined that there were unusual circumstances pertaining to the bank's activities as a de novo institution and the actions of a dominant official, and that an in-depth review (IDR) of the loss was warranted as authorized by the Financial Reform Act.

The objectives of the review were to (1) determine the causes of USA Bank's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of USA Bank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. We focused our review on the unusual circumstances mentioned above and the FDIC's response to them.

Background

USA Bank, headquartered in Port Chester, New York, was established as a state nonmember bank and insured in December 2005. The bank's approved business plan focused on residential 1-4 family and multifamily lending. However, it deviated from that plan almost immediately after opening by initiating mortgage-banking operations, relying on brokered deposits to fund growth, and operating multiple offices without providing the required regulatory notice and obtaining approval for significant changes in its operations. In late 2006, USA Bank began to focus its lending activities on commercial real estate (CRE), including acquisition, development, and construction (ADC) projects. Within the ADC portfolio, USA Bank engaged in speculative luxury home construction loans.

USA Bank did not have a holding company and had only one inactive subsidiary – USA MBA, Inc. – that was established to facilitate the bank's short-lived mortgage-banking operation. The bank's only branch was in Port Chester, Westchester County, New York. USA Bank operated in a competitive market place and held a deposit market share of less than 1 percent within Westchester County. The bank's stock was publicly traded and was widely held, with the directors and officers controlling less than 7 percent of the outstanding shares.

Audit Results

Causes of Failure and Loss

According to the FDIC, USA Bank failed due to inadequate oversight and failings on the part of the Board of Directors (Board) and management and problems attributable to concentrations in ADC and CRE lending. Poor credit administration practices and weak real estate market conditions also

contributed to the bank's failure. Additionally, the bank experienced significant losses in its 1-4 family mortgage portfolio, including home equity loans. Loan-related losses eroded capital and, on July 9, 2010, the NYSBD closed the bank due to an inadequate capital position.

Soon after it was established, the bank became plagued with deficiencies stemming from the bank's Board and management. These deficiencies can generally be attributed to the actions of the bank's founder and former Chairman of the Board (COB)/Chief Executive Officer (CEO). Under the influence of the COB/CEO, and lacking sufficient monitoring by the Board, the bank focused on CRE lending and speculative construction loans. Ultimately, such actions led to severe asset quality issues, critically deficient earnings, and inadequate capital.

With respect to the reasons we conducted this IDR, we determined that the bank's deviation from its approved business plan and the actions of a dominant official were significant factors contributing to the failure of the bank. According to the FDIC, USA Bank exhausted a significant amount of capital in its first year of operation due to unauthorized deviations from the bank's business plan.

The FDIC's Supervision of USA Bank

From the bank's inception in December 2005 through its failure in July 2010, the FDIC and the NYSBD jointly conducted three onsite examinations and six visitations of USA Bank. Through these supervisory efforts, examiners identified key risks in the bank's operations and brought these risks to the attention of the bank's Board and management through examination reports, other correspondence, and meetings. To address problems identified during the December 2006 examination, the FDIC and the NYSBD downgraded certain supervisory component ratings and the institution's composite rating and imposed parallel Cease and Desist Orders (C&Ds) in 2007. Further downgrades of supervisory ratings occurred in subsequent examinations, and the bank remained under a C&D until its closure.

As it relates to the focus of our review, the FDIC and the NYSBD identified and assessed risks associated with USA Bank's deviation from its approved de novo business plan and the actions of its dominant official. Moreover, as discussed later in the report, the FDIC and the NYSBD took definitive actions related to these risks early in, and throughout, USA Bank's existence. These actions, however, could not sufficiently mitigate the substantial risk created by the bank's early and unanticipated change to a focus on ADC and CRE lending – the primary reason that USA Bank failed.

With respect to PCA, the FDIC implemented supervisory actions that were consistent with relevant provisions of section 38.

Management Response

The Director, RMS, provided a written response, dated June 24, 2011, to a draft of the report. In its response, RMS attributed USA Bank's failure to inadequate Board and management oversight, weak loan underwriting and credit administration, and an aggressive strategy centered in CRE and ADC lending. The response reiterated statements in the report that the institution's deviation from its approved business plan and the actions of a dominant official were significant factors contributing to the failure. In addition, the response described key supervisory actions, described in the report, that the FDIC and the NYSBD took to address the bank's weak risk management practices, including deviations from the approved business plan and the Board's inadequate oversight and ceding responsibility to a dominant official.

The response stated that USA Bank's failure demonstrates why stringent supervisory attention is needed for de novo institutions and that the FDIC has extended the annual full-scope examination requirement for such institutions from 3 to 7 years. According to the response, de novo business plans receive careful analysis prior to an institution's opening and are closely monitored against approved financial projections throughout the 7-year period. Additionally, a financial institution letter was issued in August 2009 describing program changes for de novo institutions and warning that changes in business plans undertaken without required approvals may subject an institution or its insiders to civil money penalties.

Contents

	Page
Background	2
Causes of Failure and Loss	3
Deviations from Business Plan	3
Dominant Official	5
The FDIC's Supervision of USA Bank	6
Supervisory History	7
The FDIC's Application Review Process	9
Supervisory Response to Risks Related to USA Bank's Deviations from Its Business Plan	9
Supervisory Response to Risks Related to USA Bank's Dominant Official	12
Lessons Learned	13
Implementation of PCA	14
OIG Evaluation of Corporation Comments	16
Tables	
1. Selected Financial Information for USA Bank, 2006 to 2010	2
2. USA Bank's Examination History from December 2005 to July 2010	7
Appendices	
1. Objectives, Scope, and Methodology	17
2. Glossary of Terms	20
3. Acronyms	23
4. Corporation Comments	24



DATE: July 11, 2011

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Risk Management Supervision

FROM: */Signed/*
Mark F. Mulholland
Assistant Inspector General for Audits

SUBJECT: *In-Depth Review of the Failure of USA Bank, Port Chester, New York (Report No. AUD-11-011)*

The New York State Banking Department (NYSBD) closed USA Bank on July 9, 2010, and the FDIC was named as receiver. On July 29, 2010, the FDIC notified the Office of Inspector General (OIG) that USA Bank's total assets at closing were \$196.1 million and that the estimated loss to the Deposit Insurance Fund (DIF) was \$60.8 million. As of April 30, 2011, the estimated loss to the DIF had increased to \$65.2 million.

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act). The Financial Reform Act amends section 38(k) of the Federal Deposit Insurance Act (the FDI Act) by increasing the threshold for a material loss review (MLR) from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The Financial Reform Act also requires the OIG of the applicable banking agency to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or Federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that may warrant an in-depth review of the loss. Although the estimated loss for USA Bank did not meet the threshold requiring an MLR, the OIG determined there were unusual circumstances involving the bank's activities as a de novo institution and the actions of a dominant official. Accordingly, we initiated an in-depth review (IDR) of the loss as authorized by the Financial Reform Act.

Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of USA Bank's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of USA Bank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. We focused our review on the unusual circumstances mentioned above and the FDIC's response to them.

The report does not contain recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss and in-depth reviews, we will communicate those to FDIC management for its consideration.

As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC’s supervision program and make recommendations as warranted.¹

Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of terms, including material loss, the FDIC’s supervision program, and the Uniform Financial Institutions Rating System (UFIRS), otherwise known as CAMELS ratings. Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation’s comments on a draft of this report.

Background

USA Bank, headquartered in Port Chester, New York, was established as a state nonmember bank and insured in December 2005. USA Bank’s approved business plan focused on residential 1-4 family and multifamily lending. However, it deviated from that plan almost immediately after opening. Specifically, the de novo bank deviated from its approved 3-year business plan by initiating mortgage-banking operations, relying on brokered deposits to fund growth, and operating multiple offices without providing the required regulatory notice and obtaining approval for significant changes in its operations. Further, in the fourth quarter of 2006, USA Bank began to focus its lending activities on commercial real estate (CRE), including acquisition, development, and construction (ADC) projects. Within the ADC portfolio, USA Bank engaged in speculative lending in the affluent Greenwich, Connecticut, real estate market.

USA Bank did not have a holding company and had only one inactive subsidiary – USA MBA, Inc. – that was established to facilitate the bank’s short-lived mortgage-banking operation. The bank’s only branch was in Port Chester, Westchester County, New York. The bank operated in a competitive market place and held a deposit market share of less than 1 percent within Westchester County. The bank’s stock was publicly traded and was widely held, with the directors and officers controlling less than 7 percent of the outstanding shares.

Table 1 summarizes selected financial information pertaining to USA Bank for the period ending March 31, 2010 and for the preceding 4 calendar years.

Table 1: Selected Financial Information for USA Bank, 2006 to 2010

Financial Data (\$000s)	Mar 2010	Dec 2009	Dec 2008	Dec 2007	Dec 2006
Total Assets	193,299	221,527	209,933	169,474	105,586
Total Loans	162,596	165,685	153,057	113,701	71,285
Total Deposits	189,887	192,262	169,768	122,834	78,112
Net Income (Loss)	(2,664)	(13,368)	(2,692)	(4,316)	(4,509)

Source: Uniform Bank Performance Reports (UBPR) for USA Bank.

¹A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of the report.

As shown in Table 1, USA Bank was not profitable at the end of any calendar year prior to its failure. The bank's reported net losses can be attributed to a number of factors, such as high overhead, including personnel expenses, associated with the institution's attempt to initiate a mortgage-banking operation and continuing losses in its loan portfolio. From the time the bank opened in 2005 through its failure in 2010, earnings were critically deficient with losses of more than \$13 million as of year end 2009.

Causes of Failure and Loss

According to the FDIC, USA Bank failed due to inadequate oversight and failings on the part of the Board of Directors (Board) and management and problems attributable to concentrations in ADC and CRE lending. Poor credit administration practices and weak real estate market conditions also contributed to the bank's failure. Additionally, the bank experienced significant losses in its 1-4 family mortgage portfolio, including home equity loans. Loan-related losses eroded capital and, on July 9, 2010, the NYSBD closed the bank due to an inadequate capital position.

Soon after it was established, the bank became plagued with deficiencies stemming from the bank's Board and management. These deficiencies can generally be attributed to the actions of the bank's founder and former Chairman of the Board (COB)/Chief Executive Officer (CEO). Under the influence of the COB/CEO, and lacking sufficient monitoring by the Board, the bank focused on CRE lending and speculative construction loans. Ultimately, such actions led to severe asset quality issues, critically deficient earnings, and inadequate capital.

With respect to the reasons we conducted this IDR, we determined that the bank's deviation from its approved business plan and the actions of a dominant official were significant factors contributing to the failure of the bank. According to the FDIC, USA Bank exhausted a significant amount of capital in its first year of operation due to unauthorized deviations from the bank's business plan.

Deviations from Business Plan

Deviations from the bank's business plan contributed significantly to USA Bank's failure. Such deviations included (1) the establishment of a mortgage-banking operation without regulatory approval, (2) excessive reliance on non-core funding sources, and (3) a focus on ADC and CRE lending. A brief discussion of these deviations follows.

Mortgage-Banking Operation

In July 2006, the bank revised its budget to include projections relating to the formation of a mortgage-banking operation (through the formation of USA MBA, Inc.), in which real estate mortgages would be originated and sold in the secondary market. However, the FDIC was neither provided with a revised budget nor notified of bank management's intent to establish a mortgage-banking operation. According to the FDIC, this operation

was not approved by the FDIC and represented a major deviation from the bank's business plan. It also contributed to losses substantially greater than projected, resulting in critically deficient earnings. Contributing to the bank's poor earnings was a high level of non-interest expense and a low net-interest margin. Notably, personnel expenses related to the staffing of the mortgage-banking operation represented the largest segment of USA Bank's non-interest expenses.

Reliance on Non-Core Funding

From the onset of its operations, USA Bank relied heavily on non-core funding sources for its operations. Such funding was not contemplated in the bank's application for deposit insurance and had not been approved by the FDIC as a change to the bank's business plan. Specifically, the Report of Investigation (ROI) prepared by the FDIC in considering the bank's application for federal deposit insurance stated:

As the smallest competitor in the market, the proponents believe they can compete effectively for deposits by offering CD [certificates of deposit] deposit rates at/near top of market. However, the strategy is to acquire a broad base of demand accounts to lower the bank's overall cost of funds.

According to the FDIC, bank management did not have success in attracting such core deposits (i.e., demand accounts) and increasingly relied on non-core funding sources, including brokered deposits, to fund asset growth. In fact, although the bank had not projected any brokered deposits by the end of its first year of operation, such deposits totaled \$43 million (56 percent) of total deposits as of December 31, 2006.

ADC and CRE Lending

USA Bank also deviated significantly from its initial plans with respect to its lending strategy. In its application for federal deposit insurance, USA Bank defined a lending strategy that was heavily focused on loans secured by 1-4 family residential properties, which were projected to represent 44 percent of the bank's loan portfolio. However, as of December 31, 2006 (about 1 year after the bank began operation), only \$24.6 million (34 percent) of total loans were secured by 1-4 family residential properties; whereas, \$37.4 million (52 percent) of total loans were ADC and other CRE loans, which were projected to comprise only \$9.2 million (22 percent) of total loans in USA Bank's application.

The bank's growth in ADC and CRE lending increased even more significantly in 2007 and 2008. Specifically, ADC and other CRE loans totaled \$79.7 million and \$110.8 million at the end of calendar years 2007 and 2008, respectively. This shift in lending strategy had a significant negative impact on the financial condition of the bank. Between December 2007 and March 2010, ADC and other CRE charge-offs totaled \$4.3 million, or 58 percent of the total \$7.4 million in charge-offs for that period.

Dominant Official

The de novo bank operated as a classic “one-man bank,” with the COB/CEO dominating the bank’s affairs. The December 2006 examination report, which represented the first full-scope examination of USA Bank, stated that the bank’s Board and management were ineffective in identifying, measuring, monitoring, and controlling risks, and ensuring the bank’s safe and efficient operation in complying with applicable laws and regulations. The report noted that the Board had provided the COB/CEO with substantial latitude in setting the direction and goals for the bank and in leading management, apparently without adequate monitoring, evaluation, or adjustment to the processes employed or the results achieved. Further, the report stated that the COB/CEO dominated the daily affairs of the bank and, along with the Board, was responsible for the condition of the institution. On April 26, 2007, the COB/CEO resigned as CEO, but remained as COB and head of the bank’s Loan Committee until May 2, 2008.

As mentioned earlier, the bank focused its construction lending in the speculative luxury home construction market and, according to the FDIC, such lending was initiated as a result of the dominant official’s activities. The official was in charge of the bank’s business development, which involved generating potential loans. In addition, as head of the bank’s Loan Committee, the official had significant influence over the approval of loans. This situation represented an inadequate separation of duties and allowed the dominant official to have an inappropriate influence over the composition of USA Bank’s loan portfolio. In fact, the loan losses that ultimately caused the bank to fail were loans directly attributable to the official’s activities. For example, according to documentation provided by the FDIC:

- As of the March 2009 examination, 100 percent of the \$32.7 million in total adversely classified items was originated under the former COB/CEO.
- As of the November 2009 visitation, \$46.3 million (or 74 percent) of the \$62.9 million in total adversely classified loans with origination dates included in the loan write-up contained in the visitation report was originated under the former COB/CEO, as was \$5.6 million (or 94 percent) of the \$5.9 million in total loans classified as Loss.
- Certain loans were structured to circumvent section 103 of the New York State Banking Law governing the legal lending limit and resulted in \$4.0 million in loan losses for the bank.
- The COB/CEO’s actions pertaining to two borrower relationships “displayed a widespread disregard for banking policies and regulatory rules and regulations and loan losses . . . were \$1,697,687 and contributed to the failure of USA Bank.”

Following the completion of the December 2006 examination in July 2007, the FDIC issued a Cease and Desist Order (C&D) against the bank and imposed Civil Money Penalties (CMP) against each Board director. CMPs were imposed for violations of

provisions in the Order granting federal deposit insurance requiring the submission of audited bank financial statements and advance notice of plans to deviate from the approved business plan. The December 2006 examination report states that the bank's Board had experienced significant dissension and turnover that resulted in essentially a new Board – with only two original Board directors remaining. In addition, the Board hired a new bank president in July 2007. However, the new Board and bank president were not able to steer the bank to profitability and increasingly concentrated the bank's loan portfolio in higher-risk CRE and speculative construction lending, which exacerbated the bank's already weakened financial condition.

The FDIC's Supervision of USA Bank

From the bank's inception in December 2005 through its failure in July 2010, the FDIC and the NYSBD jointly conducted three onsite examinations and six visitations of USA Bank. Through these supervisory efforts, examiners identified key risks in the bank's operations and brought these risks to the attention of the bank's Board and management through examination reports, other correspondence, and face-to-face meetings. To address problems identified during the December 2006 examination, the FDIC and the NYSBD (referred to herein collectively as "the regulators") downgraded certain supervisory component ratings and the institution's composite rating and imposed parallel C&Ds in 2007. Further downgrades of supervisory ratings occurred in subsequent examinations, and the bank remained under a C&D until its closure.

As it relates to the focus of our review, the regulators identified and assessed risks associated with USA Bank's deviation from its approved de novo business plan and the actions of its dominant official. Moreover, as discussed later in the report, the regulators took definitive actions related to these risks early in, and throughout, USA Bank's existence. These actions, however, could not sufficiently mitigate the substantial risk created by the bank's early and unanticipated change to a focus on ADC and CRE lending – the primary reason that USA Bank failed.

Supervisory History

Table 2 summarizes the supervisory history for USA Bank from 2005 to 2010.

Table 2: USA Bank's Examination History from December 2005 to July 2010

Examination (Visitation) and Start (Completion) Date	Regulators	Supervisory Ratings (UFIRS)	FDIC Supervisory Action
March 7, 2006 (Visitation)	FDIC/NYSBD	N/A	None.
December 18, 2006 (July 20, 2007)	FDIC/NYSBD	224522/4	C&D effective October 22, 2007. April 2008 initiation of CMPs against the bank's Board and management.
November 26, 2007 (Visitation)	FDIC/NYSBD	N/A	2007 C&D still in effect.
February 11, 2008 (June 30, 2008)	FDIC/NYSBD	334532/4	2007 C&D still in effect.
November 3, 2008 (Visitation)	FDIC/NYSBD	N/A	2007 C&D still in effect.
March 3, 2009 (October 27, 2009)	FDIC/NYSBD	454543/5	Pursued a new C&D while the 2007 C&D was still in effect.
November 2, 2009 (Visitation)	FDIC/NYSBD	N/A	2007 C&D still in effect.
April 5, 2010 (Visitation)	FDIC/NYSBD	N/A	2007 C&D still in effect.
June 30, 2010 (Visitation)	FDIC/NYSBD	N/A	2007 C&D still in effect.

Source: The FDIC's Virtual Supervisory Information on the Net (ViSION) system and examination reports for USA Bank.

Enforcement Actions

From USA Bank's inception in December 2005 through its failure in July 2010, the FDIC and/or the NYSBD executed or proposed three enforcement actions against the bank or its Board directors.

2007 C&D. During the December 2006 Joint Examination, the regulators determined that USA Bank was not in compliance with the conditions imposed by the FDIC's Order granting federal deposit insurance. Specifically, the regulators identified ineffective Board and management oversight, several apparent violations, net losses substantially greater than projected, and deviations from the approved business plan. On

April 27, 2007, the FDIC deemed USA Bank to be in a troubled condition² and, together with the NYSBD, issued parallel C&Ds that became effective on October 22, 2007. The

² Refer to the *Glossary of Terms* in Appendix 2 for the definition of an institution in troubled condition.

C&Ds addressed management and other issues related to the bank's noncompliance with the FDIC's Order granting federal deposit insurance. Specifically, the C&Ds required the bank to, among other things:

- Engage an independent third party to conduct an assessment of the bank's management and staff.
- Immediately increase the participation of the Board in the affairs of the bank.
- Develop a comprehensive written business/strategic plan.
- Develop an internal audit program.
- Correct all violations of laws and/or regulations.
- Submit quarterly progress reports to the regulators.

Section 8(i)(2) CMP Action. During the December 2006 Joint Examination, the regulators determined that USA Bank's Board had not adequately supervised bank management. Examiners noted that the Board failed to exercise sufficient oversight with regard to laws and regulations, the conditions imposed by the FDIC's Order granting federal deposit insurance, and its fiduciary duties to the institution. As a result, on April 7, 2008, the 11 original Board directors were notified that CMPs, under section 8(i)(2) of the FDI Act, were being imposed against them. Ten of the 11 original directors stipulated to the CMPs totaling \$228,000.³

2010 C&D. During the March 2009 Joint Examination (which was completed in October 2009), examiners determined that the overall condition of USA Bank had declined dramatically due to the deterioration of its asset quality. In response to preliminary examination findings, in July 2009, the FDIC and NYSBD met with USA Bank officials. At that meeting, the Board was advised to sell/merge the institution or raise additional capital. The regulators also informed the Board that formal enforcement actions would be forthcoming. In October 2009, the FDIC and the NYSBD presented the Board with parallel C&Ds (later amended to Consent Orders). The bank's Board would not stipulate to the C&Ds, and on April 16, 2010, the FDIC filed a Notice of Charges with the Office of Financial Institution Adjudication (OFIA)⁴ to counter the bank's refusal to stipulate. Because the NYSBD did not require the institution's consent, the NYSBD imposed its C&D on USA Bank on April 22, 2010. The NYSBD's C&D required the bank to address supervisory concerns related to capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. USA Bank was closed on July 9, 2010, before the adjudication process was completed for the FDIC's Notice of Charges.

³ The remaining Board director refused to stipulate to CMPs. However, the FDIC pursued a Notice of Charges against the director for CMPs in the amount of \$5,000.

⁴ The OFIA is an office that houses administrative law judges who conduct adjudicatory hearings for the federal financial institution regulatory agencies, including the FDIC.

The FDIC's Application Review Process

Given the unusual circumstances involving the bank's activities as a de novo institution and the actions of a dominant official, we addressed the FDIC's review of the bank's application for federal deposit insurance as part of our audit.

Under the FDI Act, the FDIC's Board has responsibility for acting on all applications for federal deposit insurance by all depository institutions. Within the FDIC, the Division of Risk Management Supervision (RMS)⁵ has the responsibility for reviewing such applications. As part of this responsibility, an RMS examiner conducts a field investigation and prepares an ROI. Overall, the purpose of the ROI is to address the likelihood of the success or failure of the institution. According to the FDIC's *Risk Management Manual of Examination Policies*, the final ROI should be comprehensive and well supported and address any atypical attributes. The manual explains that examiners should review the entire application and business plan to identify potential problems, incomplete or inconsistent information, areas of non-compliance with federal and state banking statutes, and any other factors that will require additional attention.

We reviewed the FDIC's ROI, dated August 3, 2005, for USA Bank and determined that it was prepared in compliance with section 6 of the FDI Act. Specifically, the ROI addressed the seven statutory factors that must be considered by the FDIC in determining the merits of an application and detailed the relevant facts pertinent to each of the statutory factors. The examiner's opinion as to whether the criteria under each area had been met was favorable, and no negative findings requiring corrective action were identified. The ROI's *Conclusions and Recommendations* page included a description of the proposal, a summary of each statutory factor, and an overall recommendation relative to the granting of deposit insurance.

With respect to the reasons we conducted this IDR, the ROI addressed asset allocation and sources of funding – areas in which the bank deviated from its business plan. Additionally, the ROI addressed the potential impact of a dominant official at USA Bank. A more complete discussion of the ROI's coverage of these three areas is contained in the following two sections of this report.

Supervisory Response to Risks Related to USA Bank's Deviations from Its Business Plan

Overall, the FDIC took early and definitive action with respect to certain identified risks related to USA Bank's deviation from its de novo business plan. In fact, before conducting its first full-scope risk-management examination, the FDIC identified risks and took action in an attempt to correct deficiencies at the bank. Specifically, in October 2006 (just 9 months after the bank began operations and 3 months before the first onsite examination), the FDIC was made aware of and became concerned that the

⁵ Effective February 13, 2011, the Chairman of the FDIC announced several organizational changes as a result of the Financial Reform Act. One such change was to re-name the Division of Supervision and Consumer Protection as the Division of Risk Management Supervision.

bank had strayed from its approved business plan and took immediate action. For example, the bank's Board directors were asked to meet with FDIC and NYSBD officials to discuss the regulators' concerns regarding lapses in the Board's corporate governance and noncompliance with the bank's de novo business plan. At that meeting, the regulators reminded the Board directors of their fiduciary duties and liabilities and directed the Board to hire an independent firm to conduct an assessment of the Board's corporate governance.

The December 2006 Joint Examination served to corroborate the regulators' early concerns. In the resulting examination report, the regulators concluded that USA Bank's Board had not governed with sufficient regard to: prevailing laws and regulations, the conditions imposed by the Order granting federal deposit insurance, the NYSBD's stipulations for granting the Authorization Certificate (i.e., Charter), or the Board's fiduciary duties to the institution. At that examination, the regulators assigned the bank a composite "4" rating, which is indicative of institutions exhibiting unsafe and unsound banking practices or conditions.

The 2006 examination report stated that the bank's Board and management failed to comply with conditions requiring the timely submission of audited financial statements to the FDIC and a requirement for notifying the FDIC's Regional Director of proposed material deviations or changes from the de novo business plan 60 days before the consummation of the deviation or change. The examination report also identified material deviations from the de novo business plan pertaining to the bank's: entrance into the mortgage-banking business through the formation of USA MBA, Inc.; leasing of real estate associated with the mortgage-banking operation in Greenwich, Connecticut; reliance on brokered deposits for nearly 50 percent of the institution's funding sources; and establishment of an administrative office. In the FDIC's view, these unauthorized deviations from the business plan directly contributed to the bank's early deficiencies in earnings.

As discussed earlier, the FDIC and the NYSBD pursued C&Ds and CMPs due, in part, to the bank's deviation from its approved business plan. This is noteworthy because, according to New York Regional Office officials, there have been few cases where the Corporation has pursued CMPs against a bank's Board for unapproved deviations from a de novo business plan.

Given that USA Bank's failure was, to a large degree, caused by failings on the part of the Board and management and losses in the institution's ADC and CRE loan portfolios, we also considered whether the bank had deviated from its business plan with respect to the originations of such loans during the first year of operation. The 2006 examination report includes a table that compares projected financial data in the bank's federal deposit insurance application to actual results as of December 31, 2006. The table identified several variances, including the following:

- Total loan growth far exceeded USA Bank's projection. Specifically, loans at December 31, 2006 totaled \$71 million, which was \$30 million greater than the

projected \$41 million at the end of year 1. This represented a 73-percent variance.

- ADC loans at December 31, 2006 totaled about \$14.5 million, which was \$9.2 million (or 173 percent) more than the \$5.3 million projected by the bank.
- Other CRE loans (i.e., multifamily residential properties and loans secured by nonfarm, nonresidential properties) totaled about \$22.8 million at December 31, 2006, which was \$18.9 million (or 484 percent) more than the \$3.9 million projected by the bank.

In addition, although total ADC and other CRE loans were projected to represent 22 percent of USA Bank's loan portfolio at the end of the institution's first year of operation, the examination report indicated that such loans represented about 52 percent of total loans. Such variances were indications that the bank was assuming increased risk.

Further, examiners concluded in the December 2006 examination report that ". . . underwriting practices and credit administration require substantial improvement." However, the FDIC assigned USA Bank an Asset Quality component rating of "2" – indicative of satisfactory asset quality – and stated in the December 2006 examination report that "[t]he level of adversely classified assets is low relative to both loans and assets." Additionally, the FDIC stated in the examination report that USA Bank's total adversely classified assets to total assets ratio was only .47 percent. RMS officials indicated that the examination report took into account that underwriting practices and credit administration needed improvement and that this was a factor in assigning a Management component rating of "4." RMS officials further pointed out that the Management component comments in the examination report clearly reflected the Board and management's responsibility for the bank's poor risk-management practices, credit underwriting, and credit administration.

Another significant deviation from the business plan related to the bank's projected funding sources. Specifically, the ROI states, "[b]ank liabilities are projected to be exclusively centered in core deposits; no borrowings or time deposits greater than \$100,000 are anticipated." The table described above that identified variances between the bank's financial projections and actual results also showed a significant deviation from the bank's business plan with respect to funding. Specifically, although no brokered deposits were projected as of the end of the first calendar year of operation, as of December 31, 2006, such sources of funds totaled over \$43 million, or 56 percent of total deposits. Based on Call Report data, brokered deposits showed significant increases in the second and third quarters of 2006, respectively. As noted earlier in the report, the FDIC's ROI for USA Bank's deposit insurance application noted that the bank was "the smallest competitor in the market." Accordingly, there was increased risk from the initiation of the bank's operations that management would use brokered deposits to support loan growth.

According to the 2006 examination report, USA Bank was not successful in attracting core deposits and instead relied on higher-cost brokered deposits to fund asset growth. The 2006 examination report stated that the bank's reliance on brokered funds was not contemplated in the applications for deposit insurance or charter, and had not been approved by the FDIC as a change to the bank's business plan. The 2006 examination report recommended that management enhance the bank's funds management practices by establishing targeted policy limits for (a) brokered deposits to total deposits and (b) the bank's net non-core funding dependence ratio and compare these policy limits to actual results on a monthly basis.

Supervisory Response to Risks Related to USA Bank's Dominant Official

The FDIC identified the proposed COB/CEO as a potential dominant official before the bank was established. Specifically, the ROI for USA Bank, which is dated August 3, 2005—almost 5 months before the bank began operations—noted that the individual who would eventually become the COB/CEO was the spokesperson, dominant individual, and central figure in the establishment of the bank and organization of the Board. However, according to the ROI, interviews conducted with proposed Board directors tempered the FDIC's concerns about the COB/CEO's potential dominance because all proposed Board directors were adamant that they possessed the requisite strength and character to provide for a Board with the appropriate checks and balances. The FDIC's position appears to be supported by the banking experience of the proposed Board directors, as documented in the ROI.

There is evidence that the FDIC had concerns soon after USA Bank began operations that the individual who held the positions of COB and CEO was a dominant official. These concerns are reflected in the following excerpts from the December 2006 examination report.

The Board has given Chairman and CEO . . . much latitude in setting the direction and goals for the bank and in leading management, apparently without appropriate monitoring, evaluation, or adjustment to the processes employed or the results achieved. [The COB/CEO] has dominated the daily affairs of the bank and is, along with the Board, responsible for the condition of the institution.

[T]he Board nonetheless abdicated its responsibilities to [the COB/CEO].

Effective oversight and leadership are sorely needed to provide better direction, management efficiency, and motivation to the institution. Cost controls must be strengthened immediately, and operating results must be improved substantially to avoid further capital deterioration. Regulatory concerns, management deficiencies, and corrective recommendations requiring Board attention are noted throughout this Report.

According to the FDIC, a consequence of the Board's inadequate supervision was that too much influence was ceded to the COB/CEO. The FDIC also concluded that the COB/CEO was primarily responsible for the deteriorating condition of the institution.

Based in large measure on the concerns identified by FDIC and NYSBD examiners, the dominant official resigned as CEO on April 26, 2007, soon after the completion of field work on the December 2006 examination. However, the individual continued to serve as COB and head of the Loan Committee. FDIC officials contacted the institution's President during the February 2008 examination and indicated that, due to continued concerns with management, it would be in the bank's best interest for the COB to resign. On May 2, 2008, the COB resigned. Thereafter, this individual's role was that of a shareholder. Based on documentation provided to the FDIC, many of the loans that eventually caused the bank to fail were already on the bank's books when the COB/CEO resigned as the COB.

Lessons Learned

Overall, with respect to USA Bank's deviations from its de novo business plan and the activities of the dominant official, the FDIC identified the associated risks and took definitive supervisory actions. These actions, however, could not sufficiently mitigate the substantial risk created by the bank's early and unanticipated change in a focus on ADC and CRE lending – the primary reason why USA Bank failed.

As noted in the OIG report entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010, dated December 23, 2010), the OIG has identified in past MLR reports unique issues associated with "de novo" institutions. Such issues include the need for the FDIC to monitor business plans closely and to consider growth that exceeds business plan projections as a risk to be managed. In addition, these institutions relied heavily on wholesale funding sources including, but not limited to, brokered deposits and Federal Home Loan Bank Board borrowings to fund aggressive asset growth.

As it relates to the supervision of de novo institutions, the FDIC has issued guidance to examiners entitled, *Deposit Insurance Application Processing and De Novo Institution Supervision and Examination Guidance*, dated August 26, 2009, and to state nonmember financial institutions in Financial Institution Letter (FIL) 50-2009 entitled, *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions*. This guidance addresses various issues related to the supervision of de novo banks that are discussed in prior MLR reports. The guidance acknowledges that (1) depository institutions insured for less than 7 years had been over-represented in the institutions that failed during 2008 and 2009, with most of those failures occurring between the fourth and seventh years of operation, and (2) a number of newly insured institutions had pursued changes in business plans during the first few years of operation, which, in some cases, led to increased risk and financial problems when the banks' controls and risk management practices were inadequate.

The guidance also addresses the following:

- Review and approval of applications and business plans, monitoring of compliance with business plans and regulatory orders, and determination of material deviations from approved business plans;

- Prior approval of material changes to business plans;
- Recognition of associated risks;
- Examination cycles for risk management, compliance, and Community Reinvestment Act evaluations and examiner follow-up between examinations;
- Extension of the de novo period from the first 3 years to the first 7 years of a bank's operations for examinations, capital, and other requirements; and
- Consideration of supervisory actions, when determined appropriate.

Further, the FDIC has increased its use of offsite monitoring for de novo banks. Tools used to monitor de novo banks include a *De Novo Tracking Module*, developed in 2007, to facilitate variance analysis between banks' initial financial projections and actual performance over the first 3 to 5 years of operation. In addition to the tracking module, the FDIC will continue to use other offsite review techniques for monitoring de novo banks, including the Statistical CAMELS Off-site Rating, Real Estate Stress Test, and Growth Monitoring System indicators. Additionally, according to the FDIC, in April 2008, in part because of what happened at USA Bank, the New York Regional Office sent cautionary letters to all de novo banks in the region reminding them of the banks' obligations to provide the region with advance notice of any planned business plan changes.

With respect to risks associated with ADC and CRE lending, the FDIC has, among other things, provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized. The Corporation also issued supervisory guidance in 2008 addressing risks associated with this type of lending entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all insured depository institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to USA Bank, we determined that the FDIC properly implemented applicable PCA provisions of section 38. A summary of relevant PCA-related activities follows.

USA Bank was considered *Well Capitalized* at its March 2009 joint examination. The bank remained *Well Capitalized* until the June 30, 2009 Call Report was released. The Call Report showed that the bank had become *Adequately Capitalized*. The bank's capital category then fell in each successive quarter until the bank became *Critically Undercapitalized* as of March 31, 2010.

On August 19, 2009, USA Bank was informed that its capital category had dropped to *Adequately Capitalized*. As an *Adequately Capitalized* institution, USA Bank was not permitted to accept, renew, or roll over any brokered deposits unless it obtained a waiver from the FDIC. On December 8, 2009, the FDIC notified USA Bank that it had fallen to *Undercapitalized* based on the institution's September 31, 2009 Call Report. The FDIC's notification required the bank to submit a capital restoration plan within 30 days. In early January 2010, a representative of the bank contacted the FDIC's New York Regional Office and requested an extension until January 22, 2010 to submit a capital restoration plan. The Regional Office granted the extension, as allowed by section 38(e)(2) of PCA, and USA Bank submitted its capital restoration plan on that date. On February 1, 2010, while the FDIC was reviewing the bank's capital restoration plan, the bank was notified that it was *Significantly Undercapitalized*, based on the December 31, 2009 Call Report.

On March 2, 2010, the New York Regional Office notified the bank that its capital restoration plan was not acceptable because, among other things, the plan did not contain sufficient detail regarding the bank's plans for raising \$15 million in needed capital. The New York Regional Office requested that the bank submit a revised capital restoration plan within 30 days. The bank advised the regional office that it had not received the FDIC's notification of the plan's disapproval until March 19, 2010 and that the deadline for submitting a revised plan should take the associated delay into consideration. As a result, the New York Regional Office approved an April 19, 2010 deadline for a revised capital restoration plan. On April 19, 2010, the bank submitted a revised capital restoration plan. The bank was notified on May 3, 2010 that it had become *Critically Undercapitalized* for PCA purposes as of March 31, 2010.

As part of the revised capital restoration plan, a third party filed a Change of Control application with the NYSBD on May 6, 2010. The capital restoration plan was predicated on the third party infusing \$16 million in new capital in the bank. However, in a May 12, 2010 conference call, the New York Regional Office informed both bank and the third-party representatives that the \$16 million in capital was inadequate and that the revised plan would not be approved. On June 24, 2010, the third party submitted a revised investor group business/recapitalization plan. In a letter dated July 9, 2010, the New York Regional Office advised the third party that the revised plan was unacceptable because it contained a number of critical weaknesses, including an insufficient amount of capital to be injected into the bank. The NYSBD closed the bank that same day.

OIG Evaluation of Corporation Comments

The Director, RMS, provided a written response, dated June 24, 2011, to a draft of the report. The response is provided in its entirety as Appendix 4 of this report. In its response, RMS attributed USA Bank's failure to inadequate Board and management oversight, weak loan underwriting and credit administration, and an aggressive strategy centered in CRE and ADC lending. The response reiterated statements in the report that the institution's deviation from its approved business plan and the actions of a dominant official were significant factors contributing to the failure. In addition, the response described key supervisory actions, described in the report, that the FDIC and the NYSBD took to address the bank's weak risk management practices, including the institution's deviations from the approved business plan and the Board's lack of oversight and ceding responsibility to a dominant official.

The response stated that USA Bank's failure demonstrates why stringent supervisory attention is needed for de novo institutions and that the FDIC has extended the annual full-scope examination requirement for such institutions from 3 to 7 years. According to the response, de novo business plans receive careful analysis prior to an institution's opening and are closely monitored against approved financial projections throughout the 7-year period. Additionally, a Financial Institution Letter entitled, *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions*, was issued in August 2009 that describes the program changes for de novo institutions and warns that changes in business plans undertaken without required prior approval may subject an institution or its insiders to civil money penalties.

Objectives, Scope, and Methodology

Objectives

On July 21, 2010, the President signed into law the Financial Reform Act. The Financial Reform Act amends section 38(k) of the FDI Act by increasing the threshold for an MLR from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The Financial Reform Act also requires the OIG to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that may warrant an in-depth review of the loss. Although the estimated loss for USA Bank did not meet the threshold requiring an MLR, the OIG determined that an IDR of the failure of USA Bank was warranted as authorized by the Financial Reform Act.

Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this IDR were to (1) determine the causes of USA Bank's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of USA Bank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. Based on preliminary scoping work, we decided to focus our audit procedures on the FDIC's review of USA Bank's application for deposit insurance, the bank's deviation from its business plan, and the actions of a dominant bank official.

We conducted this performance audit from December 2010 through April 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of USA Bank's operations from December 2005 until its failure on July 9, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

To achieve the objectives, we performed the following procedures and techniques:

- Reviewed and/or analyzed examination and visitation reports prepared by the FDIC and the NYSBD from 2006 to 2010.
- Reviewed the following:
 - Bank data in UBPRs, Call Reports, and ViSION.
 - FDIC and NYSBD correspondence.

Objectives, Scope, and Methodology

- The FDIC's ROI and related documentation pertaining to USA Bank's application for federal deposit insurance.
- The failing bank case for USA Bank presented to the FDIC's Board of Directors.
- Pertinent FDIC policies, procedures, and guidance, and various banking laws and regulations.

We also interviewed FDIC examiners who participated in the various examinations of USA Bank and an FDIC Field Office official responsible for supervisory oversight. Additionally, we contacted officials from the NYSBD to discuss the institution's examinations and other activities regarding the State's supervision of the bank.

We performed the audit work at the OIG's offices in Arlington, Virginia.

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance with Laws and Regulations

Consistent with the audit objectives, we did not assess RMS's overall internal control or management control structure. We relied on information in RMS systems, reports, examination reports, and interviews of examiners to gain an understanding of USA Bank's management controls pertaining to causes of failure and loss as discussed in the body of this report.

We obtained data from various FDIC systems, but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems used to support our audit conclusions.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this IDR, we did not assess the strengths and weaknesses of RMS's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives. RMS's compliance with the Results Act is reviewed in program audits of RMS operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act and of the FDIC's Rules and Regulations. The results of our tests were discussed, where appropriate, in the report. Additionally, we

Objectives, Scope, and Methodology

assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR and IDR reports related to failures of FDIC-supervised institutions, and these reports can be found at www.fdicig.gov. In addition, the OIG issued an audit report entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), in December 2010. The objectives of the audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

In addition, with respect to more comprehensive coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *Prompt Corrective Action* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of CRE that provide funding for acquiring and developing land for future construction and that provide interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator, pursuant to 12 United States Code, section 1818, to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
De novo Bank	A de novo bank is a newly established bank that is in its first 7 years of operation. De novo banks are subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency.

Glossary of Terms

FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. RMS (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.
Growth Monitoring System (GMS)	GMS is an offsite rating tool that identifies institutions experiencing rapid growth or having a funding structure highly dependent on non-core funding sources.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Financial Reform Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of \$200 million.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, <i>Prompt Corrective Action</i> , of the FDI Act, 12 United States Code, section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) <i>Well Capitalized</i> , (2) <i>Adequately Capitalized</i> , (3) <i>Undercapitalized</i> , (4) <i>Significantly Undercapitalized</i> , and (5) <i>Critically Undercapitalized</i> . A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Real Estate Stress Test (REST)	REST attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that of New England in the early 1990s. REST uses statistical techniques to forecast an institution's condition over a 3- to 5-year horizon and provides a single rating from 1 to 5 in descending order of performance quality.
Statistical CAMELS Offsite Rating (SCOR) System	SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.

Glossary of Terms

Substandard	One of three types of classifications used by examiners to describe adversely classified assets. The term is generally used to describe an asset that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard assets are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
Troubled Condition	According to section 303.101(c) of the FDIC's Rules and Regulations, troubled condition means any insured depository institution that: (1) has a composite rating in its most recent examination report of 3 (only for insured depository institutions with total consolidated assets of \$10 billion or greater), 4, or 5 under UFIRS; (2) is subject to a proceeding initiated by the FDIC for termination or suspension of deposit insurance; (3) is subject to a C&D or written agreement that requires action to improve the financial condition of the institution or is subject to a proceeding which contemplates the issuance of an order that requires action to improve the financial condition of the institution; (4) is informed in writing that it is in troubled condition on the basis of the institution's most recent Call Report or report of examination, or other information available to the institution's regulator; or (5) is determined by the institution's regulator or the FDIC in consultation with the institution's regulator to be experiencing a significant deterioration of capital or significant funding difficulties or liquidity stress, notwithstanding the composite rating of the institution in its most recent report of examination.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the FFIEC for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: C apital adequacy, A sset quality, M anagement practices, E arnings performance, L iquidity position, and S ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Acronyms

ADC	Acquisition, Development, and Construction
C&D	Cease and Desist Order
CAMELS	<u>C</u> apital, <u>A</u> sset Quality, <u>M</u> anagement, <u>E</u> arnings, <u>L</u> iquidity, and <u>S</u> ensitivity to Market Risk
CEO	Chief Executive Officer
CMP	Civil Money Penalties
COB	Chairman of the Board
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
IDR	In-Depth Review
MLR	Material Loss Review
NYSBD	New York State Banking Department
OFIA	Office of Financial Institution Adjudication
OIG	Office of Inspector General
PCA	Prompt Corrective Action
RMS	Risk Management Supervision
ROI	Report of Investigation
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
ViSION	Virtual Supervisory Information on the Net

Corporation Comments



Federal Deposit Insurance Corporation

550 17th Street NW, Washington, D.C. 20429-9990

Division of Risk Management Supervision

June 24, 2011

TO: Mark Mulholland
Deputy Assistant Inspector General for Audits

FROM: **/Signed/**
Sandra L. Thompson
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, In-Depth Review of the Failure of USA Bank, Port Chester, NY (Assignment No. 2010-013)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted an In-Depth Review of the Failure of USA Bank, which failed on July 9, 2010. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report (Report) received on May 17, 2011.

USA Bank failed due to inadequate management and Board oversight, weak loan underwriting and credit administration, and an aggressive strategy centered in commercial real estate (CRE) and acquisition, development and construction (ADC) lending. Management's decision to concentrate in CRE lending, and in particular speculative, high-end construction loans, led to severe asset quality issues, critically deficient earnings performance, and an inadequate capital position. The Report also stated that USA Bank's deviation from its approved business plan and the actions of a dominant official were significant factors contributing to the failure.

From the time of USA Bank's opening in 2005 until it was closed, the FDIC and the New York State Banking Department (NYSBD) performed three examinations and six visitations. The first examination of this de novo institution in December 2006 revealed the Board had not provided sufficient oversight and turned over their responsibilities to the dominant Chairman of the Board and Chief Executive Officer. USA Bank deviated from its original business plan soon after it opened, resulting in early operational losses. Based on the 2006 examination findings the FDIC designated USA Bank in troubled condition. Subsequent to this examination and until closing, both the FDIC and NYSBD imposed several formal enforcement actions. USA Bank was unable to fully comply and unable to obtain required capital to maintain operations.

The failure of USA Bank demonstrates why stringent supervisory attention is necessary for de novo institutions. RMS has extended its supervisory program so these institutions receive a full scope examination every year for seven years, as opposed to three years. De novo business plans receive careful analysis prior to an institution's opening and are closely monitored against approved financial projections throughout the seven year period. A Financial Institution Letter, *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions* issued in August 2009 describes the program changes for de novo institutions and warns that changes in business plans undertaken without required prior approval may subject an institution or its insiders to civil money penalties.

Thank you for the opportunity to review and comment on the Report.