

# Office of Inspector General



Office of Material Loss Reviews  
Report No. MLR-11-010

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## Follow-up Audit of FDIC Supervision Program Enhancements

**Certain information regarding internal  
guidance associated with enforcement actions  
has been omitted in the publicly-issued  
version of this final report.**

December 2010



## Why We Did The Audit

Since mid-2007, a deep and prolonged housing market downturn in many areas of the United States coincided with significant disruptions to credit markets to create a much more challenging operating environment for FDIC-insured institutions. The impact of the financial crisis is evident in the significant increase in financial institution failures over the past 3 years. More specifically, the number of FDIC-insured bank failures totaled 25 in 2008 and rose to 140 during 2009. Under the Federal Deposit Insurance Act (FDI Act), when failures of FDIC-supervised institutions resulted in a material loss to the Deposit Insurance Fund, defined during that timeframe as a loss of the greater of \$25 million or 2 percent of the institution's assets at the time of closing, we were required to perform a material loss review (MLR) to determine the causes of failure and assess the FDIC's supervision of the institution.

On May 1, 2009, we 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 for eight institutions. That initial communication, in conjunction with results of our subsequent MLR work, has prompted the FDIC to take various actions to address issues we have surfaced and other supervisory matters that senior management believed warrant additional attention. As of August 20, 2010, 118 additional FDIC-insured financial institutions had failed. In addition, as of the same period, we had issued 57 more MLR reports on 64 failures of FDIC-supervised institutions.

The objectives of this audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those taken specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs. To a certain degree, we also reviewed actions implemented during 2008 that may have related to MLR trends and/or enhanced the Division of Supervision and Consumer Protection's (DSC) supervision.

## Background

As of June 30, 2010, the FDIC insured 7,830 institutions and was the primary federal regulator (PFR) for 4,814 state nonmember banks. The FDIC also has back-up supervisory responsibility for other insured institutions for which the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision are the PFRs.

The FDIC pursues the following two strategic goals in fulfilling its supervisory responsibilities as the PFR for state nonmember banks:

- FDIC-insured institutions are safe and sound and
- Consumers' rights are protected and FDIC-supervised institutions invest in their communities.

The FDIC promotes safe and sound financial institution practices through regular risk management examinations performed by DSC, publication of guidance and policy, ongoing communication with industry officials, and the review of applications submitted by FDIC-supervised institutions to expand their activities or locations. When appropriate, the FDIC has a range of informal and formal enforcement actions available to resolve safety and soundness problems identified at these institutions. The FDIC also has staff dedicated to offsite monitoring programs and enhancing the Corporation's ability to identify emerging safety and soundness issues in a timely manner.

## Audit Results

The FDIC has taken a holistic approach to enhancing supervision by (1) involving FDIC officials from various offices and divisions to participate in the Corporation's efforts and (2) implementing a comprehensive review and analysis of the FDIC's approach to supervision. As a result of these collaborative efforts, the FDIC has either implemented or planned actions that substantially address our previously reported MLR-related trends and issues, and other issues identified in subsequent MLRs that will enhance its supervision program.

Of particular note, the FDIC has:

- emphasized a forward-looking supervisory approach, which is embodied in a comprehensive training program and various financial institution and examiner guidance, including guidance related to de novo banks;
- implemented other cross-cutting initiatives such as establishing relevant *Corporate Performance Goals* in 2009 and 2010 specifically related to some MLR issues;
- implemented a post-MLR assessment process to identify lessons learned from the bank failures and conclusions included in our MLR final reports and solicit input from its examination staff regarding suggested changes to policies and procedures. This process also resulted in the identification of potential best practices related to the FDIC's examinations;
- enhanced offsite monitoring activities;
- enhanced coordination between its risk management and compliance examination functions;
- improved interagency coordination for charter conversions; and
- worked with the other federal regulatory agencies to implement a new agreement associated with the FDIC's backup examination authority.

The FDIC is also involved in interagency efforts to address some of the more systemic MLR trends, such as capital definitions and levels, and liquidity. Although it is too early to evaluate the effectiveness of the actions that the FDIC has taken, we have included recommendations for the Corporation to further improve its supervision program based on the high-level policy analysis we performed.

With respect to trends in MLRs issued since May 2009, those reports confirmed the issues previously identified and noted new trends, some of which have already been addressed in the FDIC's forward-looking supervisory approach and other initiatives. Those trends relate to:

- Government Sponsored Enterprises investments, collateralized debt obligations, collateralized mortgage obligations, and other mortgage-backed security concentrations and associated losses, and inadequate investment policies or failure to follow such policies;

- inadequate consideration of risk associated with large borrowing relationships/individual concentrations;
- purchased loan participations without adequate due diligence, credit administration, and/or consideration of the associated third-party risk;
- the need for additional enhancements to offsite monitoring activities; and
- the need for consistent notification of restrictions applicable to banks that are deemed to be *Adequately Capitalized*.

Some of our initial MLRs provided a conclusion regarding the effectiveness of Prompt Corrective Action (PCA). However, we decided not to make such conclusions in subsequent MLRs due to the complexity and scope of work involved. Instead, we opted to conduct further work related to this area that would provide more definitive information upon which to make such assessments. Accordingly, 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, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Given the limited time that had elapsed since DSC had initiated the various forward-looking supervision initiatives and issued new or updated guidance, we determined it was premature to assess their effectiveness in enhancing the supervision program. However, we are recommending that the Director, DSC, review and communicate, when deemed necessary, additional examiner and financial institution expectations in areas that we have found to be central to failures and losses to the DIF.

## **Recommendations and Management Comments**

The report contains five recommendations intended to improve DSC's supervision program. After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On December 21, 2010, the DSC Director provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC concurred with each of the five recommendations. DSC's planned actions, which are to be completed by June 30, 2011, are responsive to the OIG's recommendations. All of the recommendations are resolved and will remain open until we determine that the agreed-upon corrective actions have been completed and are responsive to the recommendations. A summary of management's response to the recommendations is provided in Appendix 5 of this report.

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**DATE:** December 23, 2010

**MEMORANDUM TO:** Sandra L. Thompson, Director  
Division of Supervision and Consumer Protection

**FROM:** */Signed/*  
Stephen M. Beard  
Assistant Inspector General for Material Loss Reviews

**SUBJECT:** *Follow-up Audit of FDIC Supervision Program  
Enhancements (Report No. MLR-11-010)*

Since mid-2007, a deep and prolonged housing market downturn in many areas of the United States coincided with significant disruptions to credit markets to create a much more challenging operating environment for FDIC-insured institutions. The impact of the financial crisis is evident in the significant increase in financial institution failures over the past 3 years. More specifically, the number of FDIC-insured bank failures totaled 25 in 2008 and rose to 140 during 2009. As of August 20, 2010, 118 additional FDIC-insured financial institutions had failed.

Under the Federal Deposit Insurance Act (FDI Act), when failures of FDIC-supervised institutions resulted in a material loss to the Deposit Insurance Fund, defined during that timeframe as a loss of the greater of \$25 million or 2 percent of the institution's assets at the time of closing, we were required to perform a material loss review (MLR) to determine the causes of failure and assess the FDIC's supervision of the institution.<sup>1</sup>

On May 1, 2009, we 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 for eight institutions. That initial communication, in conjunction with results of our subsequent MLR work, has prompted the FDIC to take various actions to address issues we have surfaced and other supervisory matters that senior management believed warrant additional attention.

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<sup>1</sup> On July 21, 2010, the President signed into law the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Financial Reform Act). The Financial Reform Act amends section 38(k) of the FDI Act by increasing the MLR threshold from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Section 987 of the Act provides for the threshold to decrease in subsequent years and eventually establishes a \$50 million threshold by January 1, 2014. In addition, the Financial Reform Act authorizes the OIG to conduct in-depth reviews (IDR) on bank failures for which the estimated loss to the DIF is below the established \$200 million threshold.

As of August 20, 2010, we had issued 57 additional MLR reports on 64 failures of FDIC-supervised institutions.<sup>2</sup> In light of this additional body of work and the time elapsed since the May 2009 memorandum, we determined that it was an appropriate time to take a snapshot of where the FDIC stood in addressing the previously identified trends and issues and what themes may have subsequently emerged. To that end, the objectives of this audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those taken specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs. To a certain degree, we also reviewed actions implemented during 2008 that may have related to MLR trends and/or enhanced DSC's supervision.

We conducted this performance audit in accordance with generally accepted government auditing standards. Appendix 1 of this report discusses our audit objectives, scope, and methodology in detail. Appendix 2 contains a glossary of key terms, including the components of the Uniform Financial Institutions Rating System (also known as the CAMELS ratings). Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report and Appendix 5 contains a summary of management's response to the recommendations.

## **Background**

As of June 30, 2010, the FDIC insured 7,830 institutions and was the primary federal regulator (PFR) for 4,814 state nonmember banks. The FDIC also has back-up supervisory responsibility for other insured institutions for which the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) are the PFRs.

The FDIC pursues the following two strategic goals in fulfilling its supervisory responsibilities as the PFR for state nonmember banks:

- FDIC-insured institutions are safe and sound and
- Consumers' rights are protected and FDIC-supervised institutions invest in their communities.

## **Risk Management Examinations**

The FDIC promotes safe and sound financial institution practices through regular risk management examinations performed by the Division of Supervision and Consumer Protection (DSC), publication of guidance and policy, ongoing communication with industry officials, and the review of applications submitted by FDIC-supervised institutions to expand their activities or locations. When appropriate, the FDIC has a

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<sup>2</sup> Three of the 57 reports covered the failure and supervision of multiple, related institutions, bringing the total number of failed banks covered by the MLRs to 72.



range of informal and formal enforcement actions<sup>3</sup> available to resolve safety and soundness problems identified at these institutions. The FDIC also has staff dedicated to offsite monitoring programs and enhancing the Corporation’s ability to identify emerging safety-and-soundness issues in a timely manner.

### Compliance Examinations

The FDIC also promotes institution compliance with consumer protection, fair lending, and community reinvestment laws through a variety of activities, including regular compliance and Community Reinvestment Act (CRA) examinations performed by DSC, the dissemination of information to consumers about their rights and required disclosures, and the investigation and resolution of consumer complaints regarding FDIC-supervised institutions. The FDIC has a range of informal and formal enforcement actions available to resolve compliance problems identified during these examinations.

### Overview of Financial Institution Failures and Associated Losses

As noted earlier, the number of FDIC-insured financial institution failures has steadily and significantly increased between 2007 and 2010. As indicated below in Table 1, the amount of estimated loss to the DIF was substantial for 2008 through August 20, 2010.

**Table 1: Total Assets and Estimated Losses to the DIF, Calendar Year 2007 Through August 20, 2010**

	2007	2008	2009	2010
<b>Total Assets and Estimated Losses Per Year</b>				
<b>Total Assets at Inception</b>	\$2.3 billion	\$361.3 billion	\$171.2 billion	\$77.5 billion
<b>Estimated Loss to DIF</b>	\$0.2 billion	\$ 19.8 billion	\$ 35.7 billion	\$18.6 billion

Source: FDIC Division of Finance (DOF) data on failed financial institutions.

### Summary of Completed Material Loss Reviews

Although not all of the bank failures resulted in a material loss to the DIF and a subsequent MLR, an overwhelming majority of the failures in January 2007 through 2010 have resulted in substantial losses and a subsequent MLR as discussed below. As indicated in Table 2, we have issued reports on the failure of 72 FDIC-supervised financial institutions between January 2007 and August 2010. Those failures were covered in 65 MLRs.

<sup>3</sup> Informal supervisory actions available to the FDIC include, but are not limited to, Bank Board Resolutions (BBR) and Memoranda of Understanding (MOU). Formal enforcement actions may include Cease and Desist Orders (C&D), Consent Orders, Civil Money Penalties (CMP), and PCA Directives.

**Table 2: Number of Failed FDIC-Supervised Banks and Completed Material Loss Reviews by Calendar Year, 2007 Through August 20, 2010**

	2007	2008	2009	2010	Total
FDIC-Supervised Banks that Failed	2	14	79	74	169
Issued MLRs <sup>a</sup> of FDIC-Supervised Bank Failures	0	11	61	0 <sup>b</sup>	72

Source: OIG analysis of FDIC-supervised bank failures and the authorities governing MLRs.

<sup>a</sup> The threshold for MLRs prior to July 21, 2010, was \$25 million or 2 percent of the failed bank's total assets. On July 21, 2010, the threshold, as defined by the Financial Reform Act, increased to \$200 million.

<sup>b</sup> As of August 20, 2010, the FDIC OIG had not issued any final MLR reports on failures that occurred beginning in January 2010. The determination of whether an MLR is required is based on DOF data on the total assets at the time the FDIC is appointed receiver and the total estimated losses to the DIF. The DOF data for January 2010 failures was not received until March 2010. Accordingly, the 6-month time frame to conduct the applicable MLRs did not start until that data was received. As a result, MLRs for that time period were due, at the earliest, in September 2010.

Although MLR reports have been issued on FDIC-supervised failed banks throughout the country, some states—such as Georgia, California, and Illinois—accounted for a large number of the MLRs that we conducted, as indicated in Table 3.

**Table 3: States with the Largest Number of FDIC-Supervised Bank Failures that Resulted in an MLR, as of August 20, 2010**

State	Number of FDIC-Supervised Bank Failures That Resulted in an Issued MLR, as of August 20, 2010
Georgia	21
California	10
Illinois	10
Florida	5
Texas	4
Washington	4
All Other States	18
<b>Total</b>	<b>72</b>

Source: FDIC DOF data and OIG-issued MLRs, as of August 20, 2010.

### Trends and Issues in the May 2009 Memorandum

As discussed previously, on May 1, 2009, we issued a memorandum to the FDIC Audit Committee and met with the FDIC Chairman on various occasions to share our perspectives on MLR trends and indicated that our initial observations on the common characteristics of failures were based on the initial eight MLRs we conducted—six final and two draft MLR reports.<sup>4</sup> For those eight institutions, assets and estimated losses to the DIF totaled \$5.1 billion and \$1.9 billion, respectively, as of August 20, 2010.

Based on that early work, we suggested that greater consideration of risk in assigning CAMELS component and composite ratings in addition to reliance on current financial condition appeared to be needed. Risky behaviors that did not seem to have had a sufficient impact on CAMELS ratings included:

<sup>4</sup> Final reports were subsequently issued for these two draft MLRs.

- Pursuit of aggressive growth in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans;
- Excessive levels of asset concentration with little risk mitigation;
- Reliance on wholesale funding to fund asset growth;
- Ineffective leadership from bank boards of directors (Board) and management;
- Inadequate loan underwriting and lack of other loan portfolio and risk management controls, including appropriate use of interest reserves;
- Allowance for loan and lease losses (ALLL) methodology and funding; and
- Compensation arrangements that were tied to quantity of loans rather than quality.

We also identified unique issues associated with “de novo” institutions, and we emphasized the need to monitor business plans closely; consider growth that exceeded the plan as a risk to be managed; and ensure that management expertise and operations/administrative structures kept pace with asset growth. We further observed that examiners generally had not used the non-capital provisions of PCA to curtail activities that contributed to losses to the DIF.

In addition to issuing the May 2009 memorandum, we communicated these issues to the DSC Director and to DSC senior management and staff by way of numerous visits to FDIC regional offices from June through September 2009, and more recently during a Regional Directors’ meeting in June 2010. Additionally, in monthly Audit Committee meetings, we presented the results of completed MLRs, and that forum focused high-level attention on MLR issues. Chairman Bair also convened a working group that met regularly for the purpose of addressing emerging supervisory issues.

## **Results of Audit**

The FDIC has taken a holistic approach to enhancing supervision by (1) involving FDIC officials from various offices and divisions to participate in the Corporation’s efforts and (2) implementing a comprehensive review and analysis of the FDIC’s approach to supervision. As a result of these collaborative efforts, the FDIC has either implemented or planned actions that substantially address our previously reported MLR-related trends and issues, and issues identified in subsequent MLRs that will enhance its supervision program.<sup>5</sup>

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<sup>5</sup> The FDIC exercises its statutory authority, in cooperation with other PFRs and state agencies, to ensure that all FDIC-insured institutions appropriately manage risk. To that end, a number of state regulatory agencies have also implemented actions to address MLR results related, but not limited, to: de novo banks, contingency liquidity planning, CAMELS downgrades, stress testing, analyzing financial institutions’ risk profiles, improving training, and prioritizing examinations.

Of particular note, the FDIC has:

- emphasized a forward-looking supervisory approach, which is embodied in a comprehensive training program and various financial institution and examiner guidance;<sup>6</sup> including guidance related to de novo banks;
- implemented other cross-cutting initiatives such as:
  - establishing relevant *Corporate Performance Goals* in 2009 and 2010 specifically related to some MLR issues; and
  - implementing a post-MLR assessment process to identify lessons learned from the bank failures and conclusions included in the OIG MLR final reports and to solicit input from its examination staff regarding suggested changes to policies and procedures. This process also resulted in the identification of potential best practices related to the FDIC's examinations;
- enhanced offsite monitoring activities;
- enhanced coordination between its risk management and compliance examination functions;
- improved interagency coordination for charter conversions; and
- worked with the other federal regulatory agencies to implement a new agreement associated with the FDIC's backup examination authority.

The FDIC is also involved in interagency efforts to address some of the more systemic MLR trends, such as capital definitions and levels, and liquidity. Although it is too early to evaluate the effectiveness of the actions that the FDIC has taken, we have included recommendations for the Corporation to consider regarding several steps to further improve its supervision program based on the high-level policy analysis we performed.

With respect to new trends in MLRs issued since May 2009, those reports confirmed the issues previously identified and noted new trends that warranted attention by the FDIC. Those trends relate to:

- Government Sponsored Enterprises investments, collateralized debt obligations (CDO), collateralized mortgage obligations (CMO), and other mortgage-backed

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<sup>6</sup> In conjunction with the DSC *Risk Management Manual of Examination Policies* and other examination manuals, the FDIC issues Regional Directors (RD) Memoranda to FDIC examiners to provide guidance on a variety of supervisory issues, including, but not limited to, the examination process and procedures, supervisory and enforcement actions, and expectations regarding examiner follow-up. In addition, the FDIC issues Financial Institution Letters (FIL) to FDIC-supervised financial institutions to announce new regulations and policies, new FDIC publications, and a variety of other matters of principal interest to those responsible for operating a bank or savings association.

- security (MBS) concentrations and associated losses, and inadequate investment policies or failure to follow such policies;
- inadequate consideration of risk associated with large borrowing relationships/individual concentrations;
  - purchased loan participations without adequate due diligence, credit administration and/or consideration of the associated third-party risk;
  - the need for additional enhancements to offsite monitoring activities; and
  - the need for consistent notification of restrictions applicable to banks that are deemed to be *Adequately Capitalized*.

Some of our initial MLRs provided a conclusion regarding the effectiveness of PCA. However, we decided not to make such conclusions in subsequent MLRs due to the complexity and scope of work involved. Instead, we opted to conduct further work related to this area that would provide more definitive information upon which to make such assessments. Accordingly, 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, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

## **Forward-Looking Supervisory Approach**

Recognizing the need to re-emphasize a supervisory approach that encompassed consideration of a financial institution's risk profile in all facets of the examination process, the FDIC (1) implemented a comprehensive training program that stresses the fundamentals of the examination process and focuses on forward-looking supervision and (2) issued additional examiner and financial institution guidance, which is discussed throughout the later sections of this report.

### ***Forward-Looking Supervision Training***

On June 26, 2009, DSC announced the *Forward-Looking Supervision* approach, which was delivered as a comprehensive training program<sup>7</sup> and reinforced in subsequent guidance. The purpose of the *Forward-Looking Supervision* initiative is to build upon the strengths of the supervision program, emphasize balanced and timely response to weak management practices and identified risks, and emphasize a forward-looking approach to examination analysis and ratings based upon the lessons learned from the recent institution failures.

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<sup>7</sup> The *Forward-Looking Supervision* training included case studies related, but not limited, to compliance, de novo banks, bank management, and assignment of CAMELS ratings, which were used to provide examiners with opportunities to consider and apply guidance to practical situations.

Developed as a response to the MLR trends and issues, the *Forward-Looking Supervision* training acknowledged the common trends included in the MLRs and concluded that while the MLRs revealed that examiners identified risks at failed institutions, the MLRs had provided lessons learned and issues for DSC's consideration in its supervisory role. Specifically, DSC concluded that (1) examination recommendations were not always effective in prompting management to take corrective action; (2) greater supervisory concern and earlier supervisory action were needed to address banks with high-risk profiles or weak risk management practices; (3) enhanced supervision was warranted for de novo banks, especially those with material deviations from their business plan; and (4) bank capital levels need to be commensurate with the risk profile of the institution.

The *Forward-Looking Supervision* training (1) emphasized that examiners should consider bank management practices as well as current and prospective financial performance and conditions or trends when assigning ratings and (2) served to improve examiners' comfort level regarding appropriate and timely corrective action when they identify weak management practices. In addition, the *Forward-Looking Supervision* training placed significant emphasis on and provided guidance related, among other things, to:

- CAMELS ratings and descriptions, including the consideration of risk rather than reliance on a bank's financial condition;
- de novo banks and review of business plans;
- risks associated with concentrations and wholesale funding sources;
- loan underwriting and administration and interest reserves;
- capital maintenance;
- *Matters Requiring Board Attention* (MRBA);<sup>8</sup>
- supervisory follow-up and enforcement actions, including Consent Orders;<sup>9</sup> and
- offsite reviews.

To further emphasize the significance of the forward-looking supervisory approach, DSC established and met its goal to provide training to the entire headquarters and regional and field office examination staff by March 31, 2010. In addition, DSC included individuals from the Conference of State Bank Supervisors in its training sessions, and state regulatory agency representatives were invited to participate in training sessions held in DSC field offices. Further, DSC regional offices enhanced their banker outreach

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<sup>8</sup> In January 2010, the FDIC issued examination guidance, entitled *Matters Requiring Board Attention*, which outlined procedures for including MRBA in examination reports and the tracking of such matters for follow-up purposes. The FDIC recognized the significance of ensuring timely communication of identified deficiencies that require attention by the bank's Board and management and timely and effective follow-up by examiners to determine the institution's progress in addressing those concerns. The FDIC tracks MRBA-related issues and identifies those actions that are outstanding and require examiner follow-up with bank management.

<sup>9</sup> The MLRs noted that, in some instances, substantial time lapsed between the identification of risks, the issuance of examination reports, and the initiation and issuance of enforcement actions. The FDIC implemented the use of Consent Orders, in part, to facilitate timely issuance of formal supervisory actions to address institution risks.

programs to reinforce the *Forward-Looking Supervision* (starting in May 2010 and continuing through December 2010).

In the future, the *Forward-Looking Supervision* concept will be incorporated into the various examiner risk management and compliance courses provided by the FDIC's Corporate University.

## **Cross-Cutting Initiatives Addressing MLR Trends**

The FDIC has taken a variety of additional steps to broadly address MLR issues and other actions to further enhance supervision. More specifically, the Corporation established *Corporate Performance Goals* to address MLR-related issues, implemented a training program emphasizing key supervisory issues, performed internal assessments of MLR results, and updated reference guides for examiners, all of which are discussed in the following sections of this report.

### **Corporate Performance Goals**

The FDIC established *Corporate Performance Goals* in 2009 and 2010 that demonstrate a focus on issues and trends identified by the MLRs. Those goals and objectives relate, but are not limited, to (1) ensuring that significant examiner concerns are brought to the attention of bank Boards and management, including significant concerns in MRBA sections of examination reports; and (2) conducting examiner follow-up to ensure that institutions take timely and effective action to address the identified problems.

### ***Back 2 Basics* Training**

Although not initiated as a specific response to the MLR results, on May 4, 2009, DSC announced the *Back 2 Basics* training to (1) provide a range of targeted courses on topics that were especially relevant in the rapidly changing financial environment, (2) provide guidance on certain examination topics that were high-profile, and (3) reinforce basic bank examination concepts and techniques. The training was developed, in part, based on information provided by FDIC examiners during a 2007 training needs survey and more recent developments in the financial industry and currently includes 12 risk management courses and 16 compliance courses.

The goal of the *Back 2 Basics* program is to ensure that commissioned examiners are fully equipped to deal with volatile changes to the nation's financial environment. As such, the *Back 2 Basics* training includes guidance on issues such as CRE and ADC lending, liquidity and funding sources, ALLL, enforcement actions, and compliance-related issues including unfair and deceptive acts and practices. The computer-based courses are available to the examination staff on an on-going basis and include self-study materials and simulations. In addition, the *Back 2 Basics* course can serve as a readily available source for addressing risk management and compliance issues that may arise during examinations.

## **Post-Material Loss Review Assessments**

On June 17, 2009, the FDIC implemented a process for the DSC regional and field offices to conduct an internal analysis when the failure of an FDIC-supervised institution causes a material loss to the DIF. Each DSC regional office is required to conduct an analysis and complete a *Post-Material Loss Review Memorandum* to be issued no later than 45 days after the receipt of the OIG's MLR report. The memorandum requires DSC regional and field offices to incorporate all appropriate and relevant feedback obtained from field examination personnel, including the field office supervisor, supervisory examiners, and examiners-in-charge as a result of their involvement in the institution's supervision and the OIG's MLR process.

As of August 23, 2010, DSC's regional offices had provided analyses for 51 MLR final reports, which outlined lessons learned and recommendations for improvement from DSC's regional and field offices on each one of the OIG's MLRs. Examiner lessons learned and recommendations related, but were not limited, to ALLL funding, CAMELS ratings, concentrations, de novo institutions and the application process to obtain deposit insurance, liquidity monitoring, management turnover and dominant bank management, rapid growth, and risk management controls.

DSC officials have developed a means to track the various lessons learned and recommendations provided by the respective regional offices and the status of those issues. For example, on March 19, 2010, DSC officials briefed the DSC Director on the types and status of lessons learned and recommendations that regional office officials had provided and whether actions already taken or planned by the FDIC addressed the recommendations.

## **On-the-Job Reference Guides**

In June 2010, DSC issued a memorandum to its regional directors that announced updates to online on-the-job (OJT) reference guides for risk management and compliance examinations. The guides were updated to include guidance issued since 2007. The guides provide instruction on issues such as ALLL, capital, liquidity, loan analysis, and internal controls.

According to the June 2010 memorandum, the guides are an informal on-the-job training tool for pre-commissioned examiners, including assistant examiners, mid-career examiners, newly hired examiners, and interns. The optional use of the guides, along with classroom-based instruction, promotes consistent training for examination staff. The guides are not intended to be a "step-by-step instruction manual" and should be used in conjunction with the *Risk Management Manual of Examination Policies* (Examination Manual),<sup>10</sup> outstanding examination guidelines, and the Examination Documentation

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<sup>10</sup> DSC is planning to update a number of examiner manuals, including the Examination Manual, to incorporate the revisions to and/or new guidance issued to examiners and financial institutions.



(ED) Modules.<sup>11</sup> Finally, the memorandum notes that the guides will be periodically reviewed to ensure they contain up-to-date training material and continue to meet the needs of pre-commissioned examiners, trainers, and supervisors.

Our review of the risk management OJT guide indicates that it includes specific references to some of the recently issued examiner guidance and refers examiners to other applicable FILs or RD Memoranda. However, we noted that the OJT reference guide for risk management did not include certain DSC guidance related to some of the common causes of bank failures identified in our MLRs. For example, the risk management loan analysis portion of the OJT guide specifically addresses FIL-104-2006, *Commercial Real Estate Lending Joint Guidance*, dated December 12, 2006 (Joint Guidance) and FIL-61-2009, *Prudent Commercial Real Estate Loan Workouts*, dated October 2009. However, we noted that the loan analysis OJT guide does not specifically include other significant CRE guidance such as:

- FIL-22-2008, *Managing CRE Concentrations in a Challenging Environment*, issued March 2008;<sup>12</sup>
- an RD Memorandum entitled, *Supervising Institutions with CRE Concentrations*, issued July 2008; and
- an RD Memorandum entitled, *Clarification of Calculation in Guidance on Commercial Real Estate*, issued April 2010.

In addition, the risk management OJT reference guide does not address de novo banks or the significant changes DSC has made to its supervisory approach and additional guidance it has issued regarding those institutions and specific requirements of bank management in them.

Consistent with the June 2010 memorandum, and in light of the extent of new guidance issued by DSC and the significant number of new examination staff hired by the division, the risk management OJT guide should be reviewed and updated to ensure it includes all significant and newly-issued guidance, especially guidance related to common causes of failure identified during the MLRs.

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<sup>11</sup> ED Modules are an examination tool that focuses on risk management practices and assists examiners in establishing the appropriate examination scope. During May 2009, September 2009, and September 2010, DSC completed updates to a large number of ED Modules, including those related to CRE concentrations and commercial and industrial loans, rate sensitivity and earnings, management and internal controls, risk scoping, related organizations, and securities, and has developed a new module that addresses brokered and high-rate deposits.

<sup>12</sup> Although not included in the loan analysis OJT guide, this FIL is included in the *Loan Underwriting Standards and Credit Administration* guide.

## **Guidance Issued and Other Steps Taken to Address Specific MLR Trends and Issues**

To address the trends identified by the MLRs and reported to the FDIC Audit Committee and Chairman, the FDIC has issued specific examiner and financial institution guidance as noted below.

### **Assignment of CAMELS Component and Composite Ratings**

The MLRs determined that the CAMELS ratings for the failed financial institutions placed greater emphasis on a bank's financial condition at the time of the examination and levels of capital and earnings, rather than the bank's ability to successfully mitigate identified risks.

CAMELS ratings are used by the federal and state regulators to assess the soundness of financial institutions on a uniform basis and to identify those institutions requiring special supervisory attention. Each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. The six component areas are **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk. The CAMELS rating system contains explicit language in each of the components emphasizing management's ability to identify, measure, monitor, and control risks. However, based on the OIG's MLR work, as indicated below, examiners did not always place sufficient emphasis on risk mitigation when assigning CAMELS ratings.

- Examiners generally identified and reported on high-risk business strategies and deficient practices, but the risks and deficiencies were not always reflected in assigned component and composite ratings.
- Bank management did not timely and effectively address examiner concerns and recommendations, and the lack of such effective action was not always reflected in the assigned CAMELS ratings until significant financial deterioration had occurred.
- Examiners frequently explained that it was their perception that the apparent financial strength of an institution, expressed in earnings and capital, limited their options for addressing elevated risk profiles. Accordingly, in many cases, examiners did not downgrade the CAMELS ratings of financial institutions with high-risk business strategies until the bank had experienced significant financial deterioration.

When these risks, either alone or in combination with one another, manifested themselves through substantial financial deterioration and losses, many institutions experienced multiple CAMELS downgrades and ultimately failed, resulting in substantial losses to the DIF.

## FDIC Actions to Address the Assignment of CAMELS Ratings

The FDIC has taken action to emphasize the importance of implementing a forward-looking approach to examinations and reflecting financial institution risks in the assigned CAMELS ratings. As discussed previously, the *Forward-Looking Supervision* initiative and related training emphasizes that:

- examiners should consider significant and/or increasing risks and high-risk business strategies that do not have adequate mitigating controls; and
- the existing ratings assessment criteria and rating definitions clearly (1) incorporate this type of forward-looking risk assessment as a consideration when assigning CAMELS component and composite ratings and (2) demonstrate that the quantity of risk and the potential adverse consequences of those risks should be considered when assigning CAMELS ratings.

First, certain guidance issued to examiners prior to the OIG's May 1, 2009 memorandum has been re-emphasized. For instance, the FDIC's July 2008 CRE guidance, *Supervising Institutions with CRE Concentrations*, states that if examiners conclude that a bank has inadequate capital for its concentrations, they should recommend that the bank increase its capital, with appropriate changes to CAMELS ratings.

The FDIC and the other regulatory agencies have also issued guidance regarding assigning and documenting appropriate ratings. For example, DSC issued examiner guidance entitled, *Documentation of CAMELS Rating Changes During the Report Review Process for Risk Management Reports of Examination*, dated July 22, 2009, which, as indicated by its title, provides information regarding the documentation of CAMELS ratings during the examination process.

In addition, recognizing that compensation arrangements can provide incentives for bank management to take imprudent risks, guidance entitled, *Guidance on Sound Incentive Compensation Policies*, dated June 21, 2010, states that supervisory findings related to incentive compensation will be communicated to institutions, included in relevant examination or inspection reports, and reflected, as appropriate, in assigned ratings.

Finally, the FDIC has other processes designed to assess the appropriateness of assigned CAMELS ratings, including (1) offsite monitoring efforts to determine whether interim changes or downgrades in CAMELS ratings are appropriate for identified risks and (2) interagency initiatives to review CAMELS rating descriptions and determine whether changes are needed in guidance related to those descriptions.

### **Assessment of Bank Boards of Directors and Management**

The Board and management for many of the failed institutions that were the subject of MLR reports failed to (1) effectively identify, measure, monitor, and control risk; (2) ensure compliance with laws, and regulations, policy, and regulatory orders; and (3) effectively manage de novo banks. In addition, some of the failed banks employed

compensation arrangements with incentive or bonus features that appeared to promote asset growth, without adequate consideration of loan quality. Further, bank management failed to provide timely and adequate attention to ensure that examiner and audit recommendations intended to correct identified deficiencies were implemented.

Our MLRs also showed that examiners sometimes identified dominant board members or senior bank management, but the institutions did not effectively mitigate the risk associated with those dominant officials. The Examination Manual indicates that there are at least two potential dangers inherent in a “One Man Bank” situation:

(1) incapacitation of the dominant officer may deprive the bank of competent management and (2) problem situations resulting from mismanagement are more difficult to solve through normal supervisory efforts. The manual notes that in “One Man Bank” situations, it is extremely important that examiners assess the bank’s control environment and, when applicable, recommend necessary changes to the control structure.

Nevertheless, we noted that the examiners frequently did not identify in examination reports a bank’s lack of controls over a dominant board member or their determination that a dominant Board member had negatively influenced bank operations until the bank’s financial condition had deteriorated and/or the last examination before the bank failed.

#### FDIC Actions to Address Bank Boards and Management

In addition to actions taken to address excessive compensation discussed previously, the following are examples of actions that the FDIC has taken to address the role that bank Boards and management have played in many of the failures that we reviewed. Specifically, the FDIC:

- implemented the *Forward-Looking Supervision* training, which recognized that the following are indicative of elevated risk associated with management: exhibiting a high appetite for risk, changing the bank’s business plan, being unresponsive to examiner recommendations, paying excessive compensation, and having a dominant official. Accordingly, examiners were instructed to address these types of issues in the MRBA section of the examination report, which is explained below.
- instituted a process that requires examiners to (1) record significant issues and recommendations that require attention by the Board in examination reports, including those related, but not limited to, high-risk business strategies, inadequate risk mitigation strategies, dominant management, and apparent violations and policy/procedural weaknesses, and (2) proactively monitor bank responses and actions to address those issues. In addition, examination reports should include an MRBA<sup>13</sup> section that focuses on issues that if not properly measured, monitored, and controlled, could adversely impact the institutions.

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<sup>13</sup> The FDIC enhanced its Virtual Supervisory Information on the Net (ViSION) system to specifically track MRBA and identify those that are outstanding. The FDIC requires examiners to follow up with bank management regarding those MRBA that are outstanding.

DSC regional offices are to include the MRBA issues in the examination report transmittal letters, request timely responses from bank management, track the recommendations, monitor the bank's progress in addressing them in the post-examination period, provide feedback to banks between examinations, and take appropriate corrective action to address inadequate or ineffective actions to address these issues.

Further, the FDIC has enhanced actions relative to the management of de novo banks, bank board and management compliance with business plans and regulatory orders, and the risk associated with those banks, as discussed in the next section of this report. Those actions require more effective communication between the banks and the FDIC regarding growth, funding strategies, concentrations, revisions to business plans, and more timely communication of requests to deviate from previously-approved business plans. In addition, the FDIC has issued more guidance to address bank management's appetite for high-risk concentrations and nonresponsiveness to examination recommendations, as discussed later in this report.

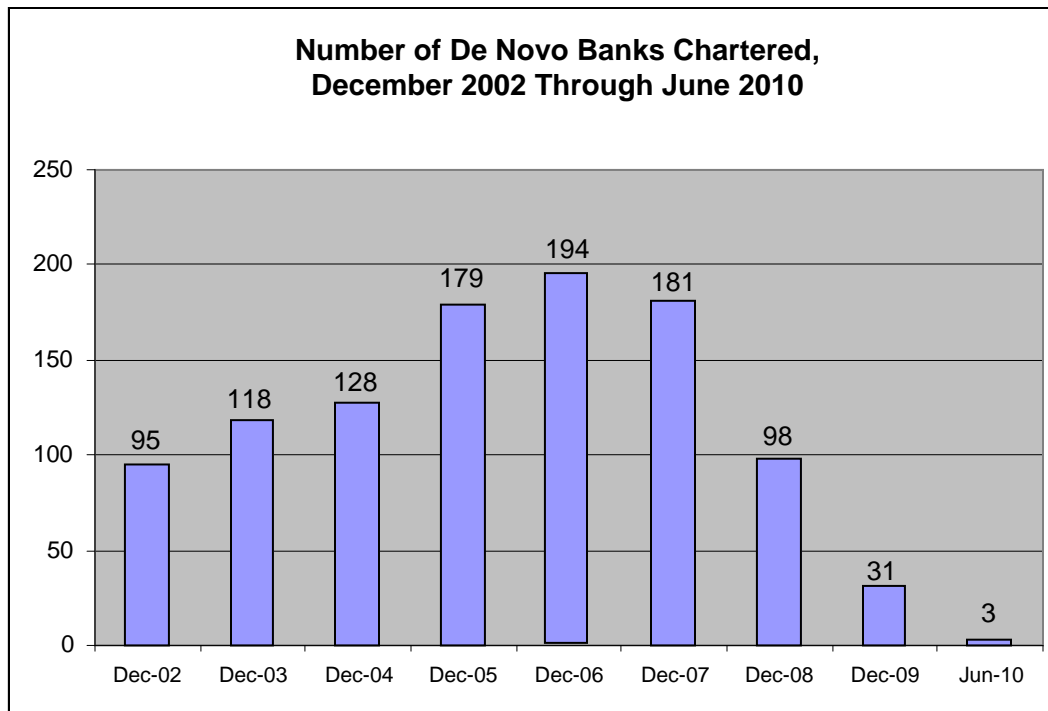
As previously discussed, DSC established an internal post-MLR assessment requirement. Our analysis of the 51 post-MLR memoranda that DSC's regional offices submitted as of August 2010 clearly indicates that, among other issues, examiners identified dominant bank officials as a significant concern and made suggestions and/or identified lessons learned regarding dominant officials. Those suggestions and/or lessons learned included the following:

- dominant officials present unique supervision challenges, and such influence without an appropriate independent Board or internal controls creates an environment for abuse and poor risk selection;
- offsite monitoring and application review, including those for de novo banks, and approvals should be enhanced to include consideration of dominant officials, coupled with other risk factors;
- director education requirements should be (1) encouraged by examiners to assist in preparing Board members to perform their responsibilities and enhance their abilities to identify potential risks and (2) included in informal corrective programs when a dominant official and a weak Board are evident in a financial institution;
- closer supervision for banks that have dominant officers should be provided and the level of involvement of individual board members needs close scrutiny; and
- a more forward-looking approach in the assessment of management and the bank's Board, especially when deficiencies have been identified related to reporting to the Board and possible "red flags" regarding a dominant officer are evident, may be needed.

At the suggestion of one of DSC’s regional offices, the *Forward-Looking Supervision* training included a case study that, according to a DSC official, (1) instructed examiners to be cognizant of “red flags” related to dominant influence or concentrations of authority during their assessment of a bank’s Board and/or management, including the assigned CAMELS rating, and (2) recognized the need for increased supervision and review of a bank’s internal controls and possible coordination with independent directors when dominant management is identified. Although the *Forward-Looking Supervision* training addressed dominant influence to some degree, we noted that the FDIC has not issued additional guidance or otherwise reemphasized existing guidance related to examination coverage and identification of risks related to institutions with dominant officials. Therefore, the FDIC should review existing examiner guidance to determine whether a reiteration of that guidance and/or communication and clarification of DSC’s expectations of its examiners with respect to this issue would be beneficial.

### Supervision of De Novo Institutions

As illustrated in the following figure, a substantial number of commercial de novo banks were chartered by state regulatory agencies and insured by the FDIC from 2002 through 2008, with the largest number of charter approvals occurring between 2004 and 2007. A substantial number of the de novo institutions chartered from 2002 through 2009 were geographically located in the DSC Atlanta and San Francisco regions.



Source: FDIC *Statistics at a Glance*, as of June 2010.

At the time we conducted our fieldwork, of the financial institutions that failed since February 2007, 75 were formed after 1999. Further, 69 percent of the de novo and “young banks”<sup>14</sup> that failed and caused a material loss to the DIF were located in DSC’s Atlanta region.

De novo banks are subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan, increased examination frequency, and higher capital requirements. In addition, de novo banks are required to comply with certain mandatory and other discretionary conditions included in regulatory orders issued by the applicable state chartering agency and the FDIC. Although many of those institutions were chartered or were attempting to establish operations during the beginning and continuation of a severe economic downturn, our MLRs identified unique issues associated with de novo institutions. Specifically, we reported that, in a number of instances, de novo banks:

- implemented business strategies that proved fatal to their viability and frequently failed to maintain a current business plan and comply with the FDIC-approved business plans and conditions included in regulatory orders, including the FDIC’s *Final Order of Approval for Deposit Insurance*; and
- quickly pursued aggressive growth in risky asset concentrations, especially CRE and/or ADC concentrations, without ensuring that adequate risk management controls were implemented to mitigate the associated risk.

In addition, these institutions frequently relied heavily on wholesale funding sources including, but not limited to, brokered deposits and Federal Home Loan Bank (FHLB) borrowings to fund aggressive asset growth. De novo institutions also tended to rapidly expand bank operations and use loan production offices to increase loan growth. Although de novo banks are expected to grow, such growth should be accomplished in a prudent manner.

#### FDIC Actions to Address De Novo Institutions

The FDIC issued additional guidance to examiners: *Deposit Insurance Application Processing and De Novo Institution Supervision and Examination Guidance*, dated August 26, 2009; and to state nonmember financial institutions in FIL-50-2009, to address issues reported in the MLRs related to the supervision of state nonmember de novo banks. 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 4<sup>th</sup> and 7<sup>th</sup> years of operation, and (2) a number of newly insured institutions had pursued changes in business plans during

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<sup>14</sup> Young banks were defined as those in the 4<sup>th</sup> through 9<sup>th</sup> years of operation. In Financial Institution Letter (FIL)-50-2009, *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions*, dated August 28, 2009, the FDIC notified financial institutions that it has extended the de novo period to include years 4 through 7 and expanded the heightened supervisory examination requirements for those banks. Although the actual failure dates for some of these banks extended into the 8<sup>th</sup> year of operation, the problems that caused the banks to fail began during the de novo phases of operation.

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 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 CRA evaluations, and examiner follow-up between examinations;
- extension of the de novo period from the first 3 years to the first 7 years for examinations,<sup>15</sup> capital, and other requirements; and
- consideration of supervisory actions, when determined appropriate.

**Business Plans.** The FDIC had been requiring de novo institutions to provide written notice of proposed changes to business plans during the first 3 years of operation but did not always require de novo banks to obtain formal written approval before implementing proposed changes. However, going forward, deposit insurance orders for state nonmember de novo institutions will require prior FDIC approval for any proposed material change or deviation in the business plan.

The FDIC will evaluate proposed material changes and determine whether the capital level, management expertise, and internal controls are sufficient to adequately manage the risks associated with the proposed change. To more closely monitor activities associated with de novo banks for a longer period, before the end of the 3<sup>rd</sup> year of operation, FDIC-supervised de novo institutions are now required to submit updated financial projections and updated business plans for years 4 through 7. Further, if a de novo institution implements a material change in its business plan without obtaining the FDIC's prior non-objection during the de novo period, the FDIC can consider assessing civil money penalties or other enforcement action.

**Examination Cycle.** For risk management examinations, a limited-scope examination will be conducted on de novo institutions within the first 6 months of operation and a full-scope examination within the first 12 months of operation. Thereafter, de novo institutions will remain on a 12-month examination cycle through the 7<sup>th</sup> year of operation. Similarly, enhanced and frequent compliance examinations have been implemented during the first 5 years of operation.

**Offsite Monitoring.** The FDIC emphasized the importance of offsite monitoring of 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

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<sup>15</sup> The extension of the de novo period to 7 years is consistent with the deposit insurance assessment rules, which generally require newly insured banks to pay higher assessments for a period longer than the first 3 years of operation. Specifically, for assessment purposes, newly-chartered banks have to pay higher premiums for the first 5 years of operation.



projections and actual performance over the first 3 to 5 years of operation. According to DSC officials, at inception, the tracking module also incorporated the ability to track the MRBA for de novo banks. However, the tracking of the MRBA for all banks has since been migrated, as of July 26, 2010, to the FDIC's ViSION system. 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 (SCOR), Real Estate Stress Test (REST), and Growth Monitoring System (GMS) indicators.

### **Examination of Commercial Real Estate and Acquisition, Development, and Construction Concentrations**

Concentrations in CRE and ADC loans, coupled with inadequate risk management practices have played a role in practically every failure that was the subject of an MLR. In addition, the inappropriate use of interest reserves by bank management was noted in many of the MLRs we conducted. In most instances, we found that bank management generally failed to implement an adequate risk management framework appropriate for the level and nature of the asset concentrations to effectively identify, monitor, and control the associated risks. Although financial institutions' CRE and ADC concentration levels that were identified significantly and consistently exceeded the levels identified for greater supervisory analysis, institutions' Boards and bank management lacked adequate (1) loan underwriting and credit administration, including appraisals, global cash flow analyses, and interest reserves, (2) portfolio stress testing, and (3) loan policies and ALLL provisions.

Regarding inadequate risk management practices, bank management did not always establish and implement sound loan policies that controlled risk in the loan portfolio. For example, failed institutions often had not required appropriate loan-to-value ratios, obtained reliable appraisals for their loans, or required borrowers to demonstrate their ability to re-pay loans apart from the sale of the underlying property. The failed institutions' loan administration functions often were under-staffed, and the banks lacked sound policies and procedures for administering loan portfolios, particularly those with higher-risk characteristics.

Regarding interest reserves, we determined that banks frequently relied heavily on interest reserves, which can mask loans that would otherwise be reported as delinquent and erode collateral protection, increasing a lender's exposure to credit losses. Further, some banks (1) extended existing borrowing arrangements, including replenishing interest reserves when payment was in doubt; (2) used interest reserves for highly speculative loans, such as land purchases; and (3) did not always track, monitor, and report on the use of interest reserves or their effect on the reported income of the institution.

## FDIC Actions to Address Risks Associated with CRE and ADC Concentrations

As discussed previously, the FDIC has provided training, issued guidance, and updated the ED Modules that examiners may use during examinations. Further, the FDIC has taken action to enhance its offsite monitoring of banks that have significant CRE concentrations and to identify emerging issues associated with those concentrations.

The FDIC's concern with ADC lending dates as far back as October 1998 when the FDIC issued FIL-110-98, *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending*, which states that ADC lending is a highly specialized field with inherent risks that must be managed and controlled to ensure that this activity remains profitable. However, regulatory concerns with ADC lending were reinforced in December 2006, when the FDIC, the OCC, and the FRB issued guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance), acknowledging that concentrations in CRE lending coupled with weak loan underwriting and depressed CRE markets had contributed to significant credit losses. The agencies reminded institutions and examiners that institutions with concentrations in CRE loans should have risk management practices and capital levels commensurate with the level and nature of their CRE concentration risk and established concentration levels that may warrant greater supervisory scrutiny. The Joint Guidance also describes a risk management framework to effectively identify, measure, monitor, and control CRE concentration risk. That framework includes effective oversight by bank management, including the Board and senior management, and sound loan underwriting, administration, and portfolio management practices.

A summary of additional guidance related to CRE and ADC concentrations, including an indication of whether the guidance addresses some of the more prevalent deficiencies noted in our MLRs, issued both before and after our May 2009 memorandum, is provided in Table 4.

**Table 4: CRE- and ADC-Related Guidance**

Date	Description of Guidance				
		Capital	Risk Management	ALLL	Interest Reserves
<b>March 2008</b>	<i>Managing CRE Concentrations in a Challenging Environment</i> issued to re-emphasize the importance of strong capital and the ALLL, and robust credit risk management practices for state nonmember institutions with significant CRE and ADC concentrations. The FIL also emphasized the need to ensure banks have sufficient staff and necessary skill sets to properly manage increased problem loans and workouts.	✓	✓	✓	✓
<b>July 2008</b>	<i>Supervising Institutions with CRE Concentrations</i> issued to update and reemphasize CRE loan examination procedures in view of the then-developing challenging market conditions, particularly in ADC lending. The guidance also states that for institutions with a significant CRE and/or ADC concentration, examiners should develop an understanding of the concentration, market conditions, effectiveness of management's underwriting and credit risk management practices, adequacy of capital, and appropriateness of the ALLL. The guidance also discusses concerns regarding the use of interest reserves.	✓	✓	✓	✓
<b>October 2009</b>	The Federal Financial Institutions Examination Council (FFIEC) <sup>16</sup> agencies issued the <i>Policy Statement on Prudent Commercial Real Estate Loan Workouts</i> to banks. The FDIC issued additional guidance in May 2010 and provided instructions for prudent loan workouts.		✓	✓	✓
<b>April 2010</b>	<i>Clarification of Calculation in Guidance on Commercial Real Estate</i> issued to address the calculation of the total CRE loan ratio specified in the 2006 Joint Guidance on <i>Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices</i> . The guidance addresses how examiners should calculate and report a bank's total owner-occupied and non-owner-occupied CRE and total CRE risk exposure commensurate with Consolidated Reports of Condition and Income instructions for reporting CRE.				

Source: DSC guidance issued to examiners.

\* DSC issued FIL-43-2009, entitled, *Allowance for Loan and Lease Losses*, which provided additional guidance on the methodologies and funding for an appropriate ALLL.

The FDIC has also used an analytical and reporting tool, implemented in late 2008, that provides quarterly analyses to identify factors likely to impact institutions and determine which institutions are most likely to be vulnerable to the risk factors identified. More specifically, the tool enables DSC's staff to assess the condition of a bank's CRE and ADC underwriting and credit administration, market areas, exposure, and compliance with the 2006 Joint Guidance. Results of the offsite monitoring are shared with DSC

<sup>16</sup> The FFIEC was established in March 1979 to prescribe uniform principles, standards, and report forms and to promote uniformity in the supervision of financial institutions. The Council has six voting members: the FRB, FDIC, National Credit Union Administration, OCC, OTS, and State Liaison Committee (composed of five representatives of state agencies that supervise financial institutions).

regional offices, which in turn conduct targeted reviews of banks with high exposure and, when determined necessary, assign interim ratings downgrades.

To further assist examiners, the FDIC has developed a comprehensive examiner resource tool that includes references to policy guidance, appraisals, examiner tools, market analyses and articles, CRE data resources, and other CRE-related guidance from agencies such as the OCC and FRB. Finally, the FDIC is participating in a review of possible lessons learned from the financial crisis and what training and/or examination guidance might be needed in this area. This review is being conducted under the auspices of the *FFIEC Task Force on Supervision*.<sup>17</sup>

### FDIC Actions to Address Risks Associated with Inadequate Credit Risk Management Practices

In addition to the Joint Guidance, Appendix A to Part 365 of the FDIC Rules and Regulations, entitled, *Interagency Guidelines for Real Estate Lending Policies*, provides guidance regarding loan portfolio management considerations, loan administration, underwriting standards, supervisory loan-to-value limits, and review of real estate lending policies. Further, Appendix A to Part 364, entitled, *Interagency Guidelines Establishing Standards for Safety and Soundness*, provides additional guidance regarding various operational and managerial standards, including, but not limited to, loan documentation, credit underwriting, and asset growth. As indicated previously in Table 4, the FDIC has issued supplemental guidance on credit risk management practices, ALLL, and interest reserves.

Regarding credit risk management practices, the guidance generally emphasizes the need for financial institutions to reflect the principles of the 2006 Joint Guidance and recognizes the importance of robust credit risk management practices. For example, FIL-22-2008, *Managing CRE Concentrations in a Challenging Environment*, specifically addresses the need to:

- increase or maintain strong capital levels;
- ensure that the ALLL methodology and funding are adequate;
- manage CRE and ADC loan portfolios closely, maintaining prudent lending policies, understanding the concentrations, developing strong credit review and risk rating systems, and effectively managing interest reserve and loan extensions;
- maintain updated financial and analytical information related, but not limited to, borrower financial statements, global financial analyses, and updated appraisals; and
- ensure the bank has an adequate loan workout infrastructure with a sufficient level of staff and with appropriate skill sets, to properly manage an increase in problem loans and workouts.

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<sup>17</sup> The *Task Force on Supervision* coordinates and oversees matters relating to safety-and-soundness supervision and examination of depository institutions, and provides a forum for the member banking agencies and State Liaison Committee to promote quality, consistency, and effectiveness in examination and supervisory practices.

In addition, RD memorandum 2008-021, *Supervising Institutions with CRE Concentrations*, states that examiners should develop a comprehensive understanding of the concentration; market conditions affecting the institution; the effectiveness of management's underwriting and credit risk management practices; the adequacy of capital; and the appropriateness of the level of the ALLL, particularly when reviewing institutions that hold a significant ADC concentration and whose loans are collateralized by properties in weak real estate markets. The guidance also states, in part, that examiners should evaluate the underwriting standards, loan administration, loan workout procedures, and conformance with Part 365 of the FDIC Rules and Regulations.

Further, in March 2009, the FDIC issued additional guidance related to appraisals in an RD memorandum entitled, *Re-appraising/Re-evaluating Real Property*. The memorandum provides guidance regarding the review of a bank's process for monitoring real estate collateral values, including CRE loans, and the determination of whether a bank's methodologies provide reliable collateral values based on current market conditions and are suitable for the bank's overall risk profile. The guidance also discusses the need for financial institutions to establish and maintain a system to identify problem assets, estimate the inherent losses, and establish sufficient reserves to absorb estimated losses. If an examiner determines the methodology to be inadequate, the guidance states that examiners should consider citing an apparent contravention to the *Interagency Appraisal and Evaluation Guidelines* or Appendix A to Part 365 and Appendix A to Part 364, as appropriate.

#### FDIC Actions to Address Risks Associated with Interest Reserves

The FDIC's concern regarding financial institutions' use of interest reserves was first noted in guidance issued by the DSC Atlanta Regional Office in November 2007. This guidance identified applicable "red flags" that may merit further investigation, possible criticism, and determination of whether a bank has sound policy regarding the use of interest reserves and the reporting of related deficiencies, and acknowledged that requesting information on interest reserves should provide insight into the level of risk in a bank's credit portfolio. The FDIC's concern regarding the inappropriate use of interest reserves was reiterated in additional guidance issued during March and July 2008, and October 2009, as noted previously in Table 4, and in the *Forward-Looking Supervision* training, which addressed the risks associated with inappropriate use of interest reserves.

Supplemental guidance regarding interest reserves was also included in a May 2008 Risk Analysis Center (RAC)<sup>18</sup> presentation, which focused on the use of interest reserves in ADC lending, examined the risks this underwriting practice presents, and reviewed regulatory guidance on the use of interest reserves. The presentation also included a discussion of "red flags" that should alert lenders to potential problems at each stage of the ADC cycle and reinforced the importance of evaluating the appropriateness of interest reserves when ADC projects become troubled. This presentation was adapted from

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<sup>18</sup> Guided by the FDIC's *National Risk Committee* and the *RAC Management Committee*, the RAC serves as a clearinghouse for information generated by the regions, sponsors a number of projects involving risk-related issues, and features presentations on risk-related topics.

*A Primer on the Use of Interest Reserves*, an article that was released in the Summer 2008 issue of the *Supervisory Insights Journal*. That article identified risks associated with interest reserves, reviewed regulatory guidance, and highlighted the importance of evaluating the appropriateness of interest reserves.

## **Large Borrowing Relationships and Individual Concentrations**

In addition to CRE and ADC concentrations, the MLRs indicated that failed financial institutions frequently developed large borrowing relationships and/or individual concentrations that resulted in substantial losses to the DIF, without implementing adequate risk management controls to mitigate the risks and frequently exceeded legal lending limits. Loans that are concentrated in one borrower, to a large degree, are predicated on the individual's financial capability, which can be significantly impacted by economic decline or overextension of credit.

### **FDIC Actions to Address Risks Associated with Large Borrowing Relationships and Individual Concentrations**

Although we identified examiner guidance related to the risks associated with large borrowing relationships and individual concentrations, we did not identify any specific guidance issued to financial institutions on this subject.

The FDIC defines an individual concentration of credit as one in which obligations of 25 percent or more of Tier 1 Capital are made to an individual borrower, small interrelated group of individuals, single repayment source, or individual project. DSC's Examination Manual provides examiner guidance related to concentrations including, but not limited to, the potential need for higher capital levels to address the associated risks and the assessment of management's ability to adequately manage the risks. In addition, the Examination Manual states that:

- bank management should consider the need to track and monitor the economic and financial condition of specific geographic locations, industries, and groups of borrowers in which the bank has invested heavily;
- all concentrations should be monitored closely by bank management and receive an in-depth review; and
- failure to monitor concentration can result in management being unaware of how significant economic events might impact the overall portfolio.

Our review of DSC's FILs did not identify any guidance specifically issued to institutions that addresses large borrowing relationships or individual concentrations of credit, although DSC officials stated that the Examination Manual is available as a reference to all insured financial institutions and includes relevant guidance. Nevertheless, given the extent to which this issue played a role in significant losses to the DIF, it may be prudent for the FDIC to more directly communicate supervisory expectations to financial

institutions that would be beneficial in their identification and mitigation of the risk associated with these concentrations.

### **Use of Non-core Sources to Fund Asset Growth**

As mentioned previously, the MLRs indicated that failed financial institutions were prone to relying heavily on non-core funding sources, especially brokered deposits,<sup>19</sup> to achieve rapid asset growth, and the extent of that funding and/or other non-core funding often significantly and consistently exceeded the bank's peer group. We also identified instances in which banks that were deemed to be *Adequately Capitalized* for PCA purposes continued to increase, roll over and/or renew brokered deposits, without an approved brokered deposit waiver, in direct contradiction to section 29 of the FDI Act and Part 337.6 of the FDIC Rules and Regulations.<sup>20</sup> In addition, the MLRs noted that financial institutions did not always have a well-developed contingency funding plan (CFP).

### **FDIC Actions to Address Risks Associated with Non-core Funding**

To address this issue, the *Forward-Looking Supervision* training emphasizes the risks that the use of non-core funding sources can present to financial institutions. Further, the FDIC has issued additional guidance regarding the consideration of brokered deposits in the deposit insurance risk assessment process, use of such funding sources for institutions that are in a weakened condition, processing of requests for brokered deposits waivers, and interest rate restrictions for banks that are less than *Well Capitalized*.

On March 2, 2009, the FDIC issued FIL-12-2009, *Deposit Insurance Assessments: Final Rule on Assessments; Amended FDIC Restoration Plan; Interim Rule on Emergency Special Assessment*, which, among other things, notified financial institutions of how brokered deposits would be considered as one of the determining factors for deposit insurance risk assessment. The consideration of brokered deposit levels as a factor in determining deposit insurance assessment rates for certain institutions pursuant to changes in the FDIC regulation regarding the risk-based assessment system became effective April 1, 2009.

In addition, according to FIL-13-2009, *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition*, dated March 3, 2009, FDIC-supervised institutions, regardless of their CAMELS ratings, that engage in aggressive growth strategies or rely excessively on a volatile funding mix are subject to heightened offsite monitoring and onsite examinations that are more extensive than for other institutions. Those funding strategies, in certain circumstances, may result in higher deposit insurance premiums. Further, those institutions that are in a weakened condition

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<sup>19</sup> Section 29 of the FDI Act and Part 337.6 of the FDIC Rules and Regulations address restrictions placed on financial institutions that are deemed to be less than *Well Capitalized* for PCA purposes, including the use of brokered deposits and interest-rate risk restrictions.

<sup>20</sup> FDIC Rules and Regulations provide that a bank is considered notified of its capital category as of the most recent (1) filing of its Call Report, (2) delivery of the final ROE, or (3) written notice from the FDIC.

(i.e., institutions rated “3”, “4”, or “5”) are expected to implement a plan to stabilize or reduce risk exposure and limit growth. The guidance also addresses requirements that may be included in corrective programs related to the use of volatile funding sources.

Section 29 of the FDI Act and Part 337.6 of the FDIC Rules and Regulations govern restrictions on the use of brokered deposits and the rate of interest paid on deposits for insured institutions that are less than *Well Capitalized* as defined in section 38 of the FDI Act. For example:

- Financial institutions that are less than *Well Capitalized* and are considered to be *Adequately Capitalized* for PCA purposes are not allowed to accept, roll over, or renew brokered deposits in accordance with section 29 of the FDI Act and Part 337.6 of the FDIC Rules and Regulations without applying for and receiving a waiver from the FDIC. In November 2009, the FDIC issued examiner guidance entitled, *Processing Brokered Deposit Waiver Requests*, to clarify procedures for expedited processing, acknowledging brokered deposit waiver requests, elevating concurrence to the headquarters level until further notice, and shortening the period for approved applications from 2 years to no longer than 6 months. To provide additional examiner guidance, the FDIC is developing a new ED Module specifically related to the examination of brokered deposits and other higher-cost deposits.
- Regarding interest rate restrictions, PCA requires the FDIC to prevent banks that are less than *Well Capitalized* from paying deposit interest rates that significantly exceed prevailing rates as defined under Part 337.6. Recognizing the challenges that the current economic conditions present to financial institutions, the FDIC issued various FILs regarding this issue:
  - FIL-25-2009, *Interest Rate Restrictions on Institutions That are Less Than Well-Capitalized*, dated May 29, 2009;
  - FIL-62-2009, *Determining Conformance with Interest Rate Restrictions for Less Than Well-Capitalized Institutions*, dated November 3, 2009;
  - FIL-69-2009, *Process for Determining If An Institution Subject to Interest-Rate Restrictions is Operating in a High-Rate Area*, dated December 4, 2009; and
  - FIL-2-2010, *Financial Institution Management of Interest Rate Risk*, dated January 20, 2010, which reminds institutions of supervisory expectations regarding sound practices for managing interest rate risk.

Further, in April 2010, the FDIC provided clarification regarding the classification of time deposits from \$100,000 to \$250,000<sup>21</sup> from non-core to core deposits. In part, the guidance states that:

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<sup>21</sup> The Financial Reform Act permanently increased the deposit insurance amount to \$250,000 and made the increase retroactive to January 1, 2008.



- examiners should continue to perform an assessment of the stability of an institution's deposit base;
- non-brokered time deposits maturing before year-end 2013 with balances between \$100,000 and \$250,000 that do not exhibit certain risk characteristics should be considered core deposits for purposes of the liquidity assessment; and
- for purposes of liquidity evaluations, examiners are expected to consider the stability of a bank's deposit base, including such factors as whether the deposits are obtained locally and the existence of an ongoing customer relationship; and brokered deposits are not included in core deposits.

In addition, the FDIC issued FIL-13-2010, *Funding and Liquidity Risk Management*, dated April 5, 2010, to re-emphasize the significance of diversified funding sources, a well-developed CFP, and expectations for each financial institution to manage funding and liquidity-related risk in a manner that is commensurate with the bank's complexity, risk profile, and operations. This guidance specifically indicated that institutions that use non-core funding sources such as brokered deposits should ensure that their CFPs address relevant stress events and outline practical and realistic funding alternatives that are accessible when funding becomes restricted.

Another common issue in our MLRs related to non-core funding is that, absent a waiver from the FDIC, banks may not accept, renew, or roll over brokered deposits when the banks are determined to be *Adequately Capitalized*. In that regard, a September 30, 1996 RD Memorandum entitled, *Use of Notification and Reconfirmation Letters Under Prompt Corrective Action*, requires that DSC send PCA notification letters to insured depository institutions that become *Undercapitalized*, *Significantly Undercapitalized*, or *Critically Undercapitalized*, for which the FDIC is the primary federal regulator. We found, however, as a matter of practice, that DSC regional offices often sent such notifications to institutions that had been determined to be *Adequately Capitalized*. Those notifications advised the bank, among other things, of the brokered deposit restrictions. In certain cases when such a notification was not provided, we determined that institutions continued to use, increased, and/or rolled over these potentially volatile deposits to fund additional growth in risky loans.

DSC officials provided copies of PCA-related notifications that its regional offices indicated are provided to *Adequately Capitalized* and *Undercapitalized* banks. DSC also emphasized that additional examiner guidance discussed later in this report addresses DSC's ability to better address risks taken by certain financial institutions, including those that increase their reliance on brokered deposits or higher-cost deposits. However, DSC has learned a great deal since issuing the guidance in 1996, and our MLRs have shown an apparent deterrent and mitigating effect associated with the *Adequately Capitalized* notifications. Therefore, it may be prudent for DSC to review existing guidance on PCA notifications and further communicate, if appropriate, DSC's expectations regarding written PCA-related notifications.

## **Assessment of Purchased Participation Loans and Security Investments**

The causes of failure for failed banks reported in the MLRs were not limited to CRE and/or ADC concentrations. Rather, those reports also noted significant losses associated with purchased participation loans and security investments and inadequate controls, including the lack of, or failure to follow, related policies to address the associated risks.

**Purchased Participation Loans.** The MLRs identified instances in which banks purchased loans outside of their lending territories in order to rapidly grow their loan portfolios or change the banks' business strategy. However, bank Boards and management purchased these loans without ensuring that adequate due diligence and credit administration were performed and without adequate consideration of the third-party risk these purchases presented to the institution. In addition, bank management did not ensure that adequate loan policies were developed or failed to ensure that staff followed established policies and concentration limits. In many cases, these purchased participation loans consisted primarily of CRE and/or ADC loans, which further increased the risks to the institution.

**Security Investments.** The MLRs reported a number of instances in which financial institutions experienced significant losses associated with concentrations and investments in CDOs, CMOs, and GSEs, such as Fannie Mae and Freddie Mac preferred stock. In addition, with respect to bank Boards and management, in some of the MLRs, we reported instances in which there was insufficient expertise to manage the investments, a lack of formal investment policies and established investment limits, inadequate methodologies to value the investments, and a lack of exit strategies to address downturns in the market. Further, we noted in some instances that, as with purchased participation loans, bank management did not ensure that staff followed established investment policies.

### **FDIC Actions to Address Purchased Participation Loans**

The FDIC has issued financial institution and examiner guidance related to third-party risk. Specifically:

- The FDIC issued FIL-44-2008, *Guidance for Managing Third-Party Risk*, dated June 6, 2008, which describes potential risk arising from third-party relationships and outlines risk management principles that may be tailored to suit the complexity and risk potential of a financial institution's significant third-party relationships.
- On January 9, 2009, the FDIC announced the creation of an ED Module that will assist examiners in assessing third-party risk to institutions. The purpose of the reference module is to support examination guidance and serve as an additional resource when evaluating practices related to management of third-party arrangements.

Although FIL-44-2008 addresses the credit risk that third-party relationships can present to financial institutions, the financial institution guidance does not appear to specifically address issues identified in the MLRs. Specifically, FIL-44-2008 does not address participation loans and the FDIC's expectation that institutions purchasing participation loans (1) must make a thorough, independent evaluation of the transaction and the risks involved before committing funds and (2) should apply the same standards of prudence, credit assessment, approval criteria, and "in-house" limits that would be employed if the institution were originating the loan.

In addition, examiner guidance included in the Examination Manual appears to be more comprehensive regarding the risks associated with purchased participation loans and states that a bank purchasing participation loans (1) is expected to perform the same degree of independent credit analysis on the loan as if it were the originator, (2) should monitor the servicing and status of the loan, and (3) should include procedures for purchasing loan participations in the bank's formal lending policy. Examiner guidance also states that if not appropriately structured and documented, a participation loan can present unwarranted risks to both the seller and purchaser of the loan. However, reference to credit risk and purchased loans in financial institution guidance provided in FIL-44-2008 is limited to the following:

Credit risk also arises from the use of third parties that market or originate certain types of loans, solicit and refer customers, conduct underwriting analysis, or set up product programs for the financial institution. Appropriate monitoring of the activity of the third party is necessary to ensure that credit risk is understood and remains within board-approved limits.

DSC officials stated that the Examination Manual is available to financial institutions and further believes that this guidance coupled with FIL-44-2008 and Appendix A of Part 364 of the FDIC Rules and Regulations sufficiently communicates DSC's expectations regarding loan participations. In our view, given the extent to which purchased loan participations and the lack of adequate risk management controls associated with the underwriting and administration of those loans contributed to significant losses to the DIF, it may be prudent for the FDIC to reiterate its supervisory expectations in this area to financial institutions.

#### FDIC Actions to Address Security Investments

The FDIC recognized that some financial institutions' securities investments such as mortgage-backed securities, CDOs, and asset-backed securities were experiencing financial deterioration due to deteriorating collateral, prices, performance, and ratings downgrades. DSC has issued updated guidance addressing risk management of investments in structured credit products that provides clarification to existing guidance. Specifically, during April 2009, the FDIC issued FIL-20-2009, *Risk Management and Investments in Structured Credit Products*. The FIL reiterates and provides clarification of existing guidance on the purchase and holding of complex structured credit products, including CDOs and MBS, and addresses credit ratings, risk limits, valuation and capital

treatment, and pre-purchase analysis. In addition, the FDIC has purchased a valuation tool that will allow the Corporation to better determine the cash flows and value of complex investment securities and, thereby, more effectively and timely identify the risks associated with those investments.

### **Issuance and Monitoring of Supervisory and Enforcement Actions**

Generally, our MLRs determined that earlier and greater supervisory concern may have been prudent to address the risk that examiners identified during examinations of failed banks that resulted in material losses to the DIF. In many cases, examiners identified significant risks but did not take timely and effective action to address those risks until the bank had started to experience significant financial deterioration in the loan or investment portfolios.

#### FDIC Actions to Address Supervisory and Enforcement Actions

Regarding supervisory and enforcement actions, the FDIC's *Forward-Looking Supervision* training addresses the need for timely communication of risks to financial institutions and prompt supervisory and enforcement actions, examiner follow-up, onsite examinations and offsite monitoring, and capital adequacy.

In addition, in July 2009, the FDIC issued an RD memorandum, entitled *Meetings, Visitations, Limited-Scope Examinations, and Quarterly Progress Reports Related to Risk Management Corrective Programs*, to emphasize the importance of monitoring institutions subject to enforcement actions and clarify expectations for quarterly progress reporting, meeting with an institution's Board at the beginning of a corrective program, and conducting onsite supervisory activities between examinations. The memorandum also emphasized that an introductory meeting with an institution's Board at the beginning of a corrective program can provide a useful forum for articulating supervisory expectations and ensuring the institution understands each of the program's requirements.

In February 2009, DSC implemented a policy to issue letters to financial institutions notifying them of concerns regarding identified risks at banks newly-rated "4" and "5" and some banks rated "3". As a follow-up to this policy, in September 2009, the FDIC issued additional guidance entitled, *Issuing Examination Letters to Troubled Institutions*, to assist in ensuring timely and effective supervisory action for institutions that are newly-rated "3", "4", and "5" and revised the applicable procedures to include banks rated "3" because previous guidance only related to banks rated "4" and "5".<sup>22</sup> The purpose of the guidance is to control new risk at the banks, such as asset growth and changes in funding strategies to increase reliance on non-core funding or high-rate deposits, temporarily insured deposits, or other government-guaranteed debt. In summary, the guidance:

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<sup>22</sup> Certain circumstances that may negate the need to issue the examination letter include instances in which banks are already subject to a C&D order or a PCA Directive.

- enhances the methods used to notify troubled banks of supervisory concerns, including potential downgrades; extends the “troubled bank” designation to include banks recently rated “3” (previously limited to banks rated “4” and “5”); provides for the issuance of *Examination Letters* to financial institutions during state examinations in which a downgrade is expected; and encourages the coordination with state regulatory agencies during state-conducted examinations;
- outlines expectations for examiners to monitor banks during the examination review period and until a corrective action program is in place—one that requires notification to the FDIC of plans for asset growth or restructure of funding to rely on brokered deposits;
- encourages the use of immediate corrective measures, including a Temporary C&D order issued pursuant to section 8(c) of the FDI Act, in certain higher-risk circumstances; and
- requires examiner follow-up to assess bank compliance with the Examination Letter, corrective actions taken by bank management to address deficiencies, and determination of whether additional supervisory action may be necessary to address bank management actions.

**[Information regarding internal guidance associated with enforcement actions has been omitted.]**

During January 2010, the FDIC issued guidance entitled, *Insured Institutions Projected Failure Report, Supervisory Histories, Prompt Corrective Action Tracking Report, and Critically Undercapitalized Institutions Report*. In addition to other instructions, the guidance provides information regarding weekly and/or quarterly reporting of institutions

that are designated as *Undercapitalized*, *Significantly Undercapitalized*, and *Critically Undercapitalized* for PCA purposes.

### **Enhanced Offsite Monitoring**

The MLRs identified instances in which offsite monitoring activities did not result in a substantial change in the supervisory strategy for the failed banks, although risks were apparent during periods before and between examinations.

#### **FDIC Actions to Address Offsite Monitoring**

Although the FDIC continues to use its traditional offsite monitoring tools, such as GMS, SCOR, and REST indicators, the Corporation has taken steps to enhance its offsite monitoring activities for various high-risk issues, including, but not limited to, de novo institutions with outstanding MRBA. Further, the FDIC identifies offsite and onsite examination metrics that more accurately recognize the risks embedded in the balance sheets and operations of highly-rated institutions that have not yet experienced significant financial deterioration.

In addition, the FDIC has strengthened various offsite monitoring systems, increased communication with DSC regional offices regarding offsite monitoring results, and uses various analytical and reporting tools to assist in identifying risk and determining which institutions may be impacted. For example, the FDIC:

- uses an analytical and reporting tool, implemented in late 2008, that provides quarterly analyses to identify factors likely to impact institutions and determine which institutions are most likely vulnerable to the risk factors identified. More specifically, the tool enables DSC's staff to assess the condition of a bank's CRE and ADC underwriting and credit administration, market areas, exposure, and compliance with the 2006 Joint Guidance. Results of these offsite monitoring activities and others are shared with DSC regional offices, which in turn are to conduct targeted reviews of banks with high exposure and, when determined necessary, assign interim ratings downgrades.
- uses automated systems to track MRBA to ensure timely and more effective examiner follow-up and determination of whether additional supervisory and/or enforcement actions may be needed for outstanding MRBA.
- has established a new risk committee to use information obtained from regional risk committee reports to identify issues for specific follow-up and analysis. The committee, which meets semiannually, is composed of DSC and Division of Insurance and Research regional and headquarters representatives who discuss existing offsite monitoring systems, supplemental offsite review lists, regional monitoring efforts, and the effectiveness of each in identifying potential downgraded institutions. As with other offsite monitoring results, these activities lead to follow-up through visitations, examinations, and/or interim rating changes, as deemed necessary.

Further, the FDIC is conducting activities to proactively identify issues that could present supervisory concern to those institutions currently rated “1” or “2”. Supervisory concerns regarding high-risk profiles and actions to enhance supervisory strategies have not been limited to banks rated “3”, “4”, or “5”, but have become more focused on banks rated “1” and “2” to identify risks before financial deterioration occurs and on emerging issues that could present a risk to the DIF. The goal of the enhanced offsite monitoring activities is to identify risks earlier, ensure that CAMELS ratings reflect such risks, and implement a supervisory approach to limit the risks. In addition, the FDIC conducts stress tests on various issues and implements a forward-looking approach to identify institutions with a higher probability of risk and greater potential for downgrades in CAMELS ratings. Such testing is based on offsite data, including economic trends, financial ratios, and examiner input on banking practices.

In addition, the FDIC conducts ad hoc offsite monitoring activities on targeted issues such as:

- the adequacy of financial institutions’ ALLL;
- financial institutions that make significant dividend payments while experiencing significant losses or obtaining funding from government-assisted programs, such as the Troubled Asset Relief Program (TARP) Capital Purchase Program (CPP) or the Temporary Liquidity Guarantee Program (TLGP) debt guaranty. As such:
  - In March 2009, the FDIC issued additional examiner guidance entitled, *Examination Guidance for Financial Institutions Receiving Subscriptions from the U.S. Department of the Treasury’s TARP CPP Program* to assess institutions’ compliance with the CPP program.
  - In addition, in September 2009, the FDIC issued additional examiner guidance entitled, *Documenting TARP CPP and TLGP Participation in Problem Bank Memoranda and Supervisory Histories*, regarding the documentation of TARP CPP and TLGP participation in memoranda related to problem banks and financial institution supervisory histories.
  - In March 2010, the FDIC issued additional guidance entitled, *Monitoring Exposures in Government Assistance Programs*, which updated examination guidance related to such government-assistance programs; and
- financial institutions with significant investments in Trust Preferred CDOs to identify institutions at risk and facilitate the FDIC’s understanding of the risk.

## **Further Enhancements to the FDIC's Supervision Program**

In addition to those actions more directly related to MLR trends and issues, the FDIC has made other enhancements to its supervision program based on (1) actions taken by DSC regional offices, which include, but are not limited to, actions to address lessons learned, training and outreach to the banking industry, and increased offsite monitoring; and (2) internal analyses. A brief summary of some other significant enhancements follows.

### **Coordination Between Risk Management and Compliance Examinations**

The FDIC's *Forward-Looking Supervision* training stressed the need to ensure effective and timely coordination between risk management and compliance examination results and supervision strategies. For example, the training emphasized:

- timely communication and coordination between DSC's risk management and compliance functions to inform one another of important issues/concerns and to schedule targeted visits as appropriate;
- the need to consider consumer protection concerns within CAMELS ratings, such as the management and liquidity components; and likewise, that relevant risk management issues should be considered by the compliance staff during the compliance assessment and ratings determinations.

### **Coordination and Approval of Charter Conversions**

Although not a direct cause of failure in any of our MLRs, some of the FDIC-supervised banks had converted to a state nonmember charter shortly before failure. To address concerns with the motives behind such charter conversions, the FDIC, the other FFIEC agencies, and state regulatory agencies have taken action to address such conversions. Specifically, during July 2009, the FDIC issued FIL-40-2009, *FFIEC Statement on Regulatory Conversions*, to reaffirm that charter conversions or changes in the PFR should only be conducted for legitimate business and strategic reasons. FIL-40-2009 states that although financial institutions may choose to operate under the state or federal charter that best accommodates their legitimate business and strategic needs:

- conversion requests submitted while serious or material enforcement actions are pending should not be entertained;
- institutions that intend to change their charter or banking supervisor will continue to seek approval through an application process with the prospective chartering authority and primary federal regulator, in consultation with state authorities;
- assigned ratings and outstanding corrective programs will remain in place following a charter conversion and/or supervisory agency change; and



- any regulatory conversion request involving an institution with a current or proposed rating of “3”, “4”, or “5” (or “Needs Improvement” or “Substantial Noncompliance” regarding CRA performance), or is subject to a serious or material current or pending corrective program, will require consultation by the prospective supervisor with the FDIC and with the Federal Reserve Board as holding company supervisor.

To facilitate an understanding of the current financial condition of the institution requesting a charter change, the prospective supervisor may choose to conduct an eligibility examination and may invite the current supervisor to participate in that examination. In addition, the current supervisor and prospective supervisor should closely coordinate regarding the examination program, including plans for ratings downgrades and enforcement actions.

### **Enhanced Backup Examination Authority**

During July 2010, the FDIC and its Board of Directors revised its previously agreed-upon *Memorandum of Understanding* with the PFRs to enhance the FDIC’s existing backup authorities for insured depository institutions for which the FDIC is not the primary regulator. The revised MOU will improve the FDIC’s ability to access information necessary to understand, evaluate, and mitigate its exposure to insured depository institutions, especially the largest and most complex.

Specifically, the revised MOU gives the FDIC back-up supervision authority under an expanded list of circumstances, including when:

- the insurance pricing system suggests an insured depository institution might be at higher risk,
- institutions are defined as “large” under international regulatory guidelines, or
- large interconnected bank holding companies are defined as “systemic” by the Financial Reform Act.

Further, the FDIC will establish an expanded continuous, full-time staff presence onsite at large, complex insured depository institutions.

### **Financial Reform Act Requirements**

In addition to the actions that the FDIC has already taken or planned to take relative to MLR-related trends, we note that the Financial Reform Act places specific requirements on the FDIC, along with other federal regulatory agencies. Regarding the FDIC, the Financial Reform Act requires the Corporation to implement actions that impact its supervisory response to MLR-related trends, as well as other issues. For example, the Financial Reform Act addresses issues such as, but not limited to, definitions of core and brokered deposits and the potential impact on the DIF, and the competitive parity

between large institutions and community banks that could result from redefining core deposits; executive compensation and corporate governance, non-recognition of trust preferred securities as regulatory capital, limitations on reliance on credit rating agencies, back-up examination and enforcement authorities, and enhanced restrictions on bank transactions with affiliates.

## **Conclusion and Recommendations**

The FDIC has responded to the MLRs we have issued in a constructive, proactive manner. Although we have opted not to make recommendations based on findings in any individual MLR, the Corporation has nevertheless taken timely corrective action to address substantially all of the issues and trends we have identified.

Given the limited time that had elapsed since DSC had initiated the various forward-looking supervision initiatives and issued new or updated guidance, we determined it was premature to assess the effectiveness of the various initiatives the FDIC has put in place to enhance its supervision program. However, we are recommending that the Director, DSC, consider taking the following steps to further improve the FDIC's supervision program based on the high-level policy analysis we performed.

- (1) Update OJT reference guides, where appropriate, to reflect significant guidance associated with common issues identified in MLRs such as CRE and ADC lending, concentrations, and de novo bank supervision.
- (2) Review existing examiner guidance addressing examination coverage and assessment of dominant bank officials and determine whether a reiteration of that guidance and/or communication and clarification of DSC's expectations in this area would be beneficial.
- (3) Review existing financial institution guidance to determine whether additional guidance related to large borrowing relationships and individual concentrations would be beneficial in communicating supervisory expectations for identifying and mitigating the risk associated with these concentrations.
- (4) Review existing guidance on PCA notifications and further communicate, if appropriate, DSC's expectations regarding written notifications of the applicable restrictions based on section 29 of the FDI Act and Part 337.6 of the FDIC Rules and Regulations to *Adequately Capitalized* banks.
- (5) Review existing financial institution guidance related to purchased participation loans to determine whether and how the FDIC could further communicate supervisory expectations regarding the controls necessary to mitigate risk associated with the participations.

We appreciate the positive and cooperative response that all levels of the FDIC have taken as a result of our MLRs. We are committed to continuing a broad, constructive

approach to sharing our perspectives with FDIC management and other stakeholders, with the goal being to protect the DIF.

In closing, organizations must continually engage in identifying and evaluating potential risks since governmental, economic, industry, legislative, and operating conditions continually change. Further, in that same vein, an organization's risk management program should periodically assess management's selected alternatives to address risk. As it relates to the supervision program, the FDIC is beginning to implement significant organizational and policy changes as a result of the Financial Reform Act and will certainly be confronted with new legislative initiatives and a changing economic landscape. As discussed earlier in our report, the FDIC Chairman, the Audit Committee, and DSC have been thoroughly engaged and supportive of our MLR reports and put mechanisms in place to ensure action is taken to address the findings. The challenge for the FDIC will be to make certain its risk management program ensures that

- lessons learned become ingrained in day-to-day supervisory activities,
- the momentum of the forward-looking supervision approach is sustained regardless of the health of the economy or banking industry,
- corrective actions discussed in this report are effective in addressing identified trends and issues, and
- new risks that emerge through changes in the Corporation's operating environment are considered and mitigated.

## **Corporation Comments and OIG Evaluation**

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On December 21, 2010, the DSC Director provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC concurred with each of the five recommendations. A summary of management's response to the recommendations is provided in Appendix 5.

In its response to recommendation 1, DSC stated that it will review the OJT reference guides for significant updates related to common issues identified in MLRs and submit any recommendations for changes to the FDIC's Course Oversight Group for its consideration. In response to recommendations 2 through 5, DSC stated that it will conduct the necessary reviews of internal and external industry guidance and communicate new guidance, as appropriate. DSC's planned actions, which are to be completed by June 30, 2011, are responsive to the OIG's recommendations. All of the recommendations are resolved and will remain open until we determine that the agreed-upon corrective actions have been completed and are responsive to the recommendations.

## Objectives, Scope, and Methodology

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### Objectives

Our audit objectives were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those taken specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

We conducted this performance audit from June 2010 to October 2010 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 actions that the FDIC had taken or planned to take in reference to MLRs conducted since the May 1, 2009 memorandum issued to the FDIC Audit Committee and the MLR-related trends and issues discussed in that memorandum. In addition, we reviewed other actions that the FDIC has taken or has planned to further enhance the Corporation's supervision. To a certain degree, we also reviewed actions implemented during 2008 that may have related to MLR trends and/or enhanced DSC's supervision.

In addition, we (1) interviewed DSC officials in Washington, D.C., and regional office officials, as appropriate; (2) reviewed the *DSC Supervision Program Enhancements*; and (3) reviewed additional examiner and financial institution guidance issued to address MLR-related trends and issues. We did not assess the effectiveness of all of the issued examiner and financial institution guidance, examinations conducted, training initiatives, or offsite monitoring activities that we reviewed because we did not believe such assessment was necessary to adequately address the audit objectives.

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

Consistent with the audit objectives, we did not assess the FDIC's overall internal control or management control structure. We relied on information in DSC reports and interviews of DSC officials to understand management controls pertaining to actions the FDIC has taken or plan to take in response to the causes of failure and supervision-related issues included in the OIG's MLRs and other actions to further enhance the FDIC's supervision program.

## Objectives, Scope, and Methodology

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We 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 *DSC Supervision Program Enhancements*, and testimonial evidence, and our review of FDIC examiner and financial institution guidance to address the audit objectives and 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 audit, we reviewed the FDIC *Annual Plan, 2008-2013 Strategic Plan, 2009 and 2010 Performance Goals and Stretch Objectives*. However, we did not assess the strengths and weaknesses of the FDIC's annual performance plan in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives. The FDIC's compliance with the Results Act is reviewed in program audits of FDIC operations.

Regarding compliance with laws and regulations, we did not perform tests to determine FDIC compliance because we concluded that such determination was not necessary to address the audit objectives. Further, we did not assess the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence because we concluded that such determination was not necessary to address the audit objectives.

### Related Coverage of Financial Institution Failures

The OIG's May 1, 2009 internal memorandum that forms the basis for this report 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 in-depth coverage of those issues and make related recommendations, when appropriate. The OIG expects to do so during 2011.

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](http://www.fdicig.gov). In addition, with respect to more in-depth 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, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

## Glossary of Terms

Term	Definition
<b>Acquisition, Development, and Construction (ADC) Loans</b>	ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and providing interim financing for residential or commercial structures.
<b>Allowance for Loan and Lease Losses (ALLL)</b>	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
<b>Cease and Desist Order (C&amp;D)</b>	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. 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.
<b>Commercial Real Estate (CRE) Loans</b>	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.
<b>Concentration</b>	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.
<b>De novo bank</b>	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.
<b>Federal Home Loan Bank (FHLB)</b>	FHLBs provide long- and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans and government and agency securities. Community financial institutions may pledge small business, small farm, and small agri-business loans as collateral for advances. Advances are priced at a small spread over comparable U.S. Department of the Treasury obligations.
<b>Growth Monitoring System (GMS)</b>	GMS is an offsite rating tool that identifies institutions experiencing rapid growth or having a funding structure highly dependent on non-core funding sources.

## Glossary of Terms

Term	Definition
<b>Interest Reserve Account</b>	An interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance. Frequently, ADC loan budgets will include an interest reserve to carry the project from origination to completion and may cover the project's anticipated sellout or lease-up period.
<b>Loan Participation</b>	The transfer of an undivided interest in all or part of the principal amount of a loan from a seller, known as the "lead", to a buyer, known as the "participant", without recourse to the lead, pursuant to an agreement between the lead and the participant. "Without recourse" means that the loan participation is not subject to any agreement that requires the lead to repurchase the participant's interest or to otherwise compensate the participant upon the borrower's default on the underlying loan.
<b>Material Loss</b>	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection 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.
<b>Memorandum of Understanding (MOU)</b>	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
<b>Offsite Review Program</b>	The Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
<b>Prompt Corrective Action (PCA)</b>	<p>The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. 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>.</p> <p>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.</p>

## Glossary of Terms

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Term	Definition
<b>Real Estate Stress Test (REST)</b>	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.
<b>Statistical CAMELS Offsite Rating (SCOR) System</b>	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.
<b>Structured Credit Product</b>	The term is broadly defined to refer to all structured investment products where repayment is derived from the performance of the underlying assets or other reference assets, or by third parties that serve to enhance or support the structure. Such products include, but are not limited to, asset-backed commercial paper programs, mortgage-backed securities or collateralized mortgage obligations, and other asset-backed securities, such as automobile and credit card-backed securities, structured investment vehicles, and collateralized debt obligations, including securities backed by TruPs.
<b>Uniform Financial Institutions Rating System (UFIRS)</b>	Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity 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.
<b>Wholesale (Non-core) Funding</b>	Wholesale funding sources include, but are not limited to, Federal funds, public funds, FHLB advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or CD listing services. Financial institutions may use wholesale funding sources as an alternative to core deposits to satisfy funding and liability management needs.



## Acronyms

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ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
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
CDO	Collateralized Debt Obligation
CFP	Contingency Funding Plan
CMO	Collateralized Mortgage Obligation
CPP	Capital Purchase Program
CRA	Community Reinvestment Act
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DOF	Division of Finance
DSC	Division of Supervision and Consumer Protection
ED	Examination Documentation
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
FRB	Board of Governors of the Federal Reserve System
GMS	Growth Monitoring System
IDR	In-depth Review
MBS	Mortgage-Backed Security
MLR	Material Loss Review
MOU	Memorandum of Understanding
MRBA	Matters Requiring Board Attention
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
OJT	On-the-Job Training
PCA	Prompt Corrective Action
PFR	Primary Federal Regulator
RD	Regional Director
REST	Real Estate Stress Test
SCOR	Statistical CAMELS Offsite Rating
TARP	Troubled Asset Relief Program
TLGP	Temporary Liquidity Guarantee Program

## Corporation Comments

**Federal Deposit Insurance Corporation**

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

Division of Supervision and Consumer Protection

December 21, 2010

**TO:** Stephen M. Beard  
Assistant Inspector General for Material Loss Reviews,  
Office of Inspector General

**FROM:** /Signed/  
Sandra L. Thompson [signed by Sandra L. Thompson]  
Director, Division of Supervision and Consumer Protection

**SUBJECT:** Response to Draft Report Entitled:  
*Follow-up Audit of FDIC's Supervision Program Enhancements (2010-066)*

The Division of Supervision and Consumer Protection (DSC) has received and considered the recommendations from the recent *Follow-up Audit of the FDIC's Supervision Program Enhancements*. We appreciate that your report acknowledges the Federal Deposit Insurance Corporation (FDIC) has taken a constructive, proactive, and holistic approach to enhancing its supervision program by addressing issues identified in material loss reviews (MLRs).

The OIG audit report contains recommendations for DSC to review and reinforce as necessary internal guidance for two supervisory areas: 1) examination coverage and assessment of dominant bank officials; and 2) Prompt Corrective Action notifications and DSC's expectations regarding written notification to 'Adequately Capitalized' banks of the applicable restrictions associated with Section 29 of the FDI Act and Part 337.6 of the FDIC Rules and Regulations. The OIG also recommends that DSC reviews external guidance issued to the financial industry and determines the appropriate need for communicating further guidance for supervisory expectations of risk mitigation for large borrowing relationships and individual concentrations, as well as purchased participation loans. By June 30, 2011, DSC will conduct the necessary reviews of internal and external industry guidance and communicate new guidance, as appropriate.

In addition, the OIG recommends that DSC updates the on-the-job training (OJT) reference guides, where appropriate, to reflect significant guidance associated with common issues identified in MLRs, such as commercial real estate and acquisition, development, and construction lending; asset and liability concentrations; and de novo bank supervision. The content of the OJT reference guides are reviewed periodically to ensure these documents remain current and continue to meet the needs of pre-commissioned examiners, trainers, and supervisors. By June 30, 2011, DSC will review the OJT reference guides for significant updates related to common issues identified in MLRs and submit any recommendations for changes to the Course Oversight Group for its consideration.

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

## Management Response to Recommendations

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This table presents the management response on the recommendations in our report and the status of the recommendations as of the date of report issuance.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved: Yes or No <sup>a</sup>	Open or Closed <sup>b</sup>
1	DSC agreed with this recommendation and stated that it will review the OJT reference guides for significant updates related to common issues identified in MLRs and submit any recommendations for changes to the Course Oversight Group for its consideration.	June 30, 2011	N/A	Yes	Open
2	DSC agreed with this recommendation. DSC will conduct the necessary reviews of internal and external industry guidance related to dominant bank officials and communicate new guidance, as appropriate.	June 30, 2011	N/A	Yes	Open
3	DSC agreed with this recommendation. DSC will conduct the necessary reviews of internal and external industry guidance related to large borrowing relationships and individual concentrations and communicate new guidance, as appropriate.	June 30, 2011	N/A	Yes	Open
4	DSC agreed with this recommendation. DSC will conduct the necessary reviews of internal and external industry guidance related to written notifications of applicable restrictions to <i>Adequately Capitalized</i> banks and communicate new guidance, as appropriate.	June 30, 2011	N/A	Yes	Open
5	DSC agreed with this recommendation. DSC will conduct the necessary reviews of internal and external industry guidance related to purchased participation loans and communicate new guidance, as appropriate.	June 30, 2011	N/A	Yes	Open

- <sup>a</sup> Resolved – (1) Management concurs with the recommendation, and the planned, ongoing, and completed corrective action is consistent with the recommendation.  
(2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation.  
(3) Management agrees to the OIG monetary benefits, or a different amount, or no (\$0) amount. Monetary benefits are considered resolved as long as management provides an amount.

<sup>b</sup> Once the OIG determines that the agreed-upon corrective actions have been completed and are responsive to the recommendations, the recommendations can be closed.