



Material Loss Review of First Republic Bank

November 2023

EVAL-24-03

Evaluation Report Audits, Evaluations, and Cyber



Integrity ☆ Independence ☆ Accuracy ☆ Objectivity ☆ Accountability



NOTICE

Pursuant to Pub. L. 117-263, section 5274, non-governmental organizations and business entities identified in this report have the opportunity to submit a written response for the purpose of clarifying or providing additional context to any specific reference. Comments must be submitted to comments@fdicoig.gov within 30 days of the report publication date as reflected on our public website. Any comments will be appended to this report and posted on our public website. We request that submissions be Section 508 compliant and free from any proprietary or otherwise sensitive information.



Date: November 28, 2023

Memorandum To: Doreen R. Eberley
Director, Division of Risk Management Supervision

/s/

From: Terry L. Gibson
Assistant Inspector General for Audits, Evaluations, and Cyber

Subject | **Material Loss Review of First Republic Bank** | Report No. EVAL-24-03

This memorandum transmits Cotton & Company Assurance and Advisory, LLC's (Cotton) Material Loss Review of First Republic Bank. Under a contract monitored by this office, we engaged Cotton to perform this Material Loss Review. The contract required the Material Loss Review be performed in accordance with the Council of the Inspectors General on Integrity and Efficiency Quality Standards for Inspection and Evaluation.

The objectives of the engagement were to (1) determine why the bank's problems resulted in a material loss to the Deposit Insurance Fund, and (2) evaluate the FDIC's supervision of the bank, including the FDIC's implementation of the Prompt Corrective Action requirements of Section 38 of the Federal Deposit Insurance Act, and make recommendations for preventing any such loss in the future.

In its Material Loss Review, Cotton determined that:

- The FDIC missed opportunities to take earlier supervisory actions and downgrade First Republic Bank component ratings consistent with the FDIC's forward-looking supervisory approach;
- The FDIC assessed First Republic Bank's uninsured deposits consistent with FDIC policies, but the magnitude and velocity of uninsured deposit outflows warrants the FDIC's re-evaluation of assumptions and guidance pertaining to uninsured deposits; and
- First Republic Bank was well-capitalized throughout each examination cycle based on defined capital measures, but that the bank's failure may warrant changes to the guidelines establishing standards for safety and soundness, including the adoption of noncapital triggers requiring regulatory actions.

This report contains 11 recommendations intended to improve the FDIC's supervision processes and its ability to apply effective forward-looking supervision in a changing banking environment. The FDIC concurred with all of these recommendations and plans to complete corrective actions by July 31, 2024.

Cotton is responsible for the attached report dated November 28, 2023, and the information and conclusions expressed in the report. As a result, with the oversight provided by our office, we relied upon the statements and conclusions derived by Cotton. Cotton performed the work from May through November 2023. This review fulfills a statutory mandate and does not serve any investigatory purposes.

We appreciate the cooperation and courtesies provided to Cotton and our office during the Material Loss Review. If you have any questions, please do not hesitate to contact me at (703) 562-2529.

Material Loss Review of First Republic Bank

Section 38, *Prompt Corrective Action*, of the Federal Deposit Insurance (FDI) Act requires the Inspector General (IG) of the appropriate federal banking agency to conduct a review and issue a written report when there is a material loss to the Deposit Insurance Fund (DIF) related to an insured depository institution for which the Federal Deposit Insurance Corporation (FDIC) is appointed receiver. The California Department of Financial Protection and Innovation (DFPI) closed First Republic Bank (First Republic) and appointed the FDIC as receiver on May 1, 2023. The FDIC recorded a final estimated loss to the DIF of \$15.6 billion on June 5, 2023.

The FDIC supervises insured state-chartered banks that are not members of the Federal Reserve System, state-chartered savings associations, and insured state-chartered branches of foreign banks. First Republic was a state-chartered nonmember commercial bank headquartered in San Francisco, California with no holding company or affiliates. First Republic was regulated jointly by the FDIC and the DFPI.

The FDIC Office of Inspector General (OIG) engaged the professional services firm of Cotton & Company Assurance and Advisory, LLC (Cotton) to conduct this Material Loss Review. The objectives of the engagement were to (1) determine why the bank's problems resulted in a material loss to the DIF and (2) evaluate the FDIC's supervision of the bank, including the FDIC's implementation of the Prompt Corrective Action requirements of Section 38 of the FDI Act, and make recommendations for preventing any such loss in the future.

Results

Causes of Failure and Material Loss to the Deposit Insurance Fund

First Republic's failure was caused by contagion effects stemming from the failure of other prominent financial institutions, which led to a run on deposits, significantly reducing its liquidity and exposing vulnerabilities in First Republic's business strategy. Specifically, First Republic's strategy of attracting high net-worth customers with competitive loan terms, and funding growth through low-cost deposits, resulted in a concentration of uninsured deposits while increasing the bank's sensitivity to interest rate risk in a rising rate environment. This strategy ultimately led to a significant asset/liability mismatch for the bank, and fair value declines on its portfolio of low-yielding, long-duration loans, which limited its ability to obtain sufficient liquidity and prevented its recovery.

The FDIC's Supervision of First Republic Bank

In its Material Loss Review, Cotton determined that:

- The FDIC missed opportunities to take earlier supervisory actions and downgrade First Republic component ratings consistent with the FDIC's forward-looking supervisory approach;
- The FDIC assessed First Republic's uninsured deposits consistent with FDIC policies, but the magnitude and velocity of uninsured deposit outflows warrants the re-evaluation of assumptions and guidance pertaining to uninsured deposits; and
- First Republic was well-capitalized throughout each examination cycle based on defined capital measures, but that the bank's failure may warrant changes to the guidelines establishing standards for safety and soundness, including the adoption of noncapital triggers requiring regulatory actions.

Recommendations

This report contains 11 recommendations intended to improve the FDIC's supervision processes and its ability to apply effective forward-looking supervision and protect the DIF in a changing banking environment. Specifically, Cotton recommended an evaluation of the FDIC's processes for rating downgrades and the need for additional communications or adjustments to its training curriculum. Additionally, Cotton recommended that the FDIC ensure examination guidance requires supervisory action when bank business practices consistently deviate from policies, procedures, or risk appetite metrics. Cotton also recommended that the FDIC assess whether a revision to examination guidance is warranted in the areas of uninsured deposits and bank contagion risk characteristics. Further, Cotton recommended that the FDIC implement the matters for further study from the FDIC's September 2023 Chief Risk Officer report regarding the monitoring of large bank reputational risk and the consideration of unrealized losses and declines in the fair value of assets. Lastly, Cotton recommended that the FDIC evaluate the need for changes to rules under the safety and soundness standards, including the adoption of noncapital triggers requiring regulatory actions.

The FDIC concurred with all 11 recommendations. The FDIC plans to complete all corrective actions by July 31, 2024.

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Part I

Report by Cotton & Company Assurance
and Advisory, LLC



Cotton

A  SIKICH COMPANY

SUBMITTED TO
FEDERAL DEPOSIT INSURANCE CORPORATION
OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW OF FIRST REPUBLIC BANK

NOVEMBER 28, 2023



A  SIKICH COMPANY

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November 28, 2023

Terry L. Gibson
Assistant Inspector General for Audits, Evaluations, and Cyber
Office of Inspector General
Federal Deposit Insurance Corporation

Subject: Material Loss Review of First Republic Bank

Cotton & Company Assurance and Advisory, LLC (Cotton) is pleased to submit the attached report detailing the results of our material loss review (MLR) of First Republic Bank to the Federal Deposit Insurance Corporation's (FDIC's) Office of Inspector General (OIG).

We conducted this MLR in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* (commonly referred to as the Blue Book). In addition, we conducted this engagement in accordance with the American Institute of Certified Public Accountants' *Statement on Standards for Consulting Services*.

We performed our work from May 2023 through November 2023 at the Cotton office in Alexandria, Virginia and remotely.

Sincerely,

COTTON & COMPANY ASSURANCE AND ADVISORY, LLC

/s/ Jesse J. Carpenter, CPA
Partner

/s/ Steven M. Koons, CPA
Partner

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MATERIAL LOSS REVIEW OF FIRST REPUBLIC BANK

INTRODUCTION

The following sections present Federal Deposit Insurance (FDI) Act, 12 U.S.C. § 1831o, requirements and our objectives for this material loss review (MLR) of First Republic Bank (i.e., “First Republic” or “the Bank”).

FDI Act Requirements

Section 38, *Prompt Corrective Action*, of the FDI Act requires the Inspector General (IG) of the appropriate federal banking agency to conduct a review and issue a written report when there is a material loss¹ to the Deposit Insurance Fund (DIF) related to an insured depository institution for which the Federal Deposit Insurance Corporation (FDIC) is appointed receiver.

Engagement Objectives

On May 1, 2023, the California Department of Financial Protection and Innovation (DFPI) closed First Republic and appointed the FDIC as receiver. The FDIC recorded a final estimated loss to the DIF of \$15.6 billion on June 5, 2023. As of December 31, 2022—according to the *Consolidated Reports of Condition and Income* (Call Report)—First Republic reported about \$212.6 billion in total assets and \$176.4 billion in total deposits. Based on the amount of total assets, First Republic was the second largest bank failure in U.S. history at the time.

The FDIC Office of Inspector General (OIG) engaged Cotton & Company Assurance and Advisory, LLC (i.e., “Cotton”, “we”, “us”, or “our”) to conduct the First Republic MLR in accordance with the Council of the Inspectors General on Integrity and Efficiency’s *Quality Standards for Inspection and Evaluation* (commonly referred to as the Blue Book). In addition, we conducted this engagement in accordance with the American Institute of Certified Public Accountants’ *Statement on Standards for Consulting Services*. The objectives of our engagement were to (1) determine why First Republic’s problems resulted in a material loss to the DIF and (2) evaluate the FDIC’s supervision of First Republic, including the FDIC’s implementation of the Prompt Corrective Action (PCA) requirements of Section 38 of the FDI Act, and make recommendations for preventing any such loss in the future.

We conducted this MLR independent from other assessments of First Republic. The information in this report was obtained during the period May through November 2023. In conducting our work and preparing the report, we relied primarily on supervisory records, bank documents, and other information provided by the FDIC’s Division of Risk Management Supervision (RMS). This review fulfills a statutory mandate and does not serve any investigatory purposes. Our

¹ FDI Act, Section 38(k), *Reviews Required When Deposit Insurance Fund Incurs Losses*, defines the term “material loss” as any estimated loss in excess of “\$50,000,000, if the loss occurs on or after January 1, 2014, provided that if the inspector general of a Federal banking agency certifies to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives that the number of projected failures of depository institutions that would require material loss reviews for the following 12 months will be greater than 30 and would hinder the effectiveness of its oversight functions, then the definition of ‘material loss’ shall be \$75,000,000 for a duration of 1 year from the date of the certification.” 12 U.S.C. § 1831o(k).

Objectives, Scope, and Methodology are presented in **Appendix I**. Acronyms and abbreviations are presented in **Appendix IV**.

BACKGROUND

This section presents information on the supervision of First Republic and a brief summary of events; a summary of other public discussion on the failure of First Republic and other prominent regional banks, and recently proposed rules; and an overview of the FDIC's supervisory activities, including those for large banks, such as First Republic.

Supervision of First Republic and Brief Summary of Events

The FDIC supervises insured state-chartered banks that are not members of the Federal Reserve System, state-chartered savings associations, and insured state-chartered branches of foreign banks. First Republic Bank was a state-chartered nonmember commercial bank headquartered in San Francisco, California, with no holding company. First Republic was regulated jointly by the FDIC and the DFPI.

First Republic was originally formed in 1985 and operated until 2007 when it was acquired by Merrill Lynch. In 2010, the original Bank management led a buyout to re-establish First Republic as an independent entity, and a new bank charter was approved. First Republic became a publicly-traded company via Initial Public Offering (IPO) in December 2010. It traded under ticker symbol FRCB. First Republic focused on high-net-worth customers, offering multiple services including residential real estate lending, private banking, business banking, wealth management, trust, and brokerage services. First Republic focused on urban coastal markets with dense populations and targeted urban professionals as its core client base. Additionally, First Republic's assets were primarily comprised of loans with a concentration in Single Family Residential (SFR) loans. At the time of failure, First Republic had 84 branches located in California, Connecticut, Florida, Massachusetts, New York, Washington, and Wyoming.

First Republic grew quickly in the years before its failure. As of December 31, 2022, total assets were \$212.6 billion. **Table 1** below depicts First Republic's asset growth from 2018 through 2022:

Table 1: Growth Summary

As of December 31	Total Assets (\$ in Millions)	Percent Change from Prior Year
2022	\$ 212,639	17.4
2021	181,087	27.1
2020	142,502	22.6
2019	116,264	17.2
2018	99,205	13.0

Source: First Republic's *Consolidated Reports of Condition and Income* (Call Reports).

During March 2022, in response to inflationary pressures, the Federal Open Market Committee (FOMC)² began to raise interest rates. In total, from March 2022 through March 2023, there were nine different rate increases, which increased the effective federal funds rate³ from 0.25 to 5.00 percent. Although the 5.00 percent effective federal funds rate in March 2023 was not historically high, it was the highest rate since 2007. As demonstrated in **Figure 1** below, rates reached levels as high as 19 percent during 1980. However, from 2009 through March 2022, there was a prolonged period of low interest rates compared to historical levels, followed by an aggressive series of increases.

Figure 1: Historical Effective Federal Funds Rate



Source: Federal Reserve Bank of St. Louis.

Other Public Discussion on the Failure of First Republic and Other Prominent Regional Banks, and Recently Proposed Rules

Prior to the issuance of this MLR report, there has been much attention given to the May 1, 2023, failure of First Republic; the self-liquidation of Silvergate Bank announced on March 8,

²According to the Federal Reserve, it controls three tools of monetary policy--open market operations, the discount rate, and reserve requirements. The Board of Governors of the Federal Reserve System is responsible for the discount rate and reserve requirements, and the FOMC is responsible for open market operations. Using the three tools, the Federal Reserve influences the demand for, and supply of, balances that depository institutions hold at Federal Reserve Banks and in this way alters the effective federal funds rate. The effective federal funds rate is the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight. Changes to the effective federal funds rate trigger a chain of events that affect other short-term interest rates, foreign exchange rates, long-term interest rates, the amount of money and credit, and, ultimately, a range of economic variables, including employment, output, and prices of goods and services.

³ According to the Federal Reserve Bank of St. Louis, the effective federal funds rate is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight. The effective federal funds rate is the central interest rate in the U.S. financial market. It influences other interest rates such as the prime rate, which is the rate banks charge their customers with higher credit ratings. Additionally, the effective federal funds rate indirectly influences longer-term interest rates such as mortgages, loans, and savings.

2023; and the failures of Silicon Valley Bank (SVB) and Signature Bank of New York (SBNY) on March 10 and 12, 2023, respectively.

There have been congressional hearings that have related to First Republic's failure, including by the U.S. House of Representatives Financial Services Committee on May 16, 2023⁴, and by the U.S. Senate Banking, Housing and Urban Affairs Committee on May 18, 2023⁵. The House Financial Services Committee also held a hearing with the leadership of recently failed banks on May 17, 2023⁶, including the former Chief Executive Officer and President of First Republic.

The FDIC issued a proposed rule on July 27, 2023, to strengthen capital requirements for large banks⁷. The FDIC also issued proposed rules on August 29, 2023, to strengthen resolution planning for large banks, and to require large banks to maintain long-term debt to improve financial stability and resolution⁸. Evaluation of the FDIC proposed rules are not within the scope of this MLR.

The FDIC Chief Risk Officer (CRO) issued *FDIC's Supervision of First Republic Bank* on September 8, 2023.⁹ The report discusses causes of First Republic's failure and the FDIC's supervision of First Republic. The CRO's matters for further study are included for reference in **Appendix II**. Cotton conducted its MLR independent from the CRO's review of First Republic.

Overview of the FDIC's Supervisory Activities

Responsibility for supervising and overseeing large state nonmember banks is shared between the FDIC's Regional Offices¹⁰ and its Large Bank Supervision (LBS) Branch within RMS. The FDIC's *RMS Manual of Examination Policies* (the Manual) explains that the FDIC "conducts bank examinations to ensure public confidence in the banking system and to protect the Deposit Insurance Fund" and that Sections 10(b) and (c) of the FDI Act "empower examiners to make a thorough examination of a bank's affairs".

The FDIC established safety and soundness standards in accordance with Section 39, *Standards for Safety and Soundness*, of the FDI Act. Under these standards, the FDIC assesses institutions' risk management practices primarily considering the guidelines for the safe and sound operation of banks set forth in Section II of Part 364 of the FDIC Rules and Regulations, Appendix A¹¹. These guidelines set safety and soundness standards that the FDIC uses to identify and address problems at institutions before capital becomes impaired.

As part of the examination process, the FDIC rates the institutions it supervises using the Uniform Financial Institutions Rating System (UFIRS) ratings. UFIRS contains six component

⁴ <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408768>

⁵ <https://www.banking.senate.gov/hearings/oversight-of-financial-regulators-financial-stability-supervision-and-consumer-protection-in-the-wake-of-recent-bank-failures>

⁶ Joint Hearing Entitled: Continued Oversight Over Regional Bank Failures (Subcommittees on Financial Institutions and Monetary Policy and Oversight and Investigations) (May 17, 2023).

<https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408778>

⁷ <https://www.fdic.gov/news/press-releases/2023/pr23055.html>

⁸ <https://www.fdic.gov/news/press-releases/2023/pr23066.html>

⁹ <https://www.fdic.gov/news/press-releases/2023/pr23073a.pdf>

¹⁰ The FDIC's Regional Offices are located in Atlanta, Georgia; Chicago, Illinois; Kansas City, Missouri; Dallas, Texas; New York, New York; and San Francisco, California.

¹¹ <https://www.fdic.gov/regulations/laws/rules/2000-8630.html#fdic2000appendixatopart364>

ratings, described in detail below. Those component ratings are referred to by the acronym CAMELS, which is a commonly used term when referring to UFIRS ratings.

CAMELS Ratings

The FDIC is part of the Federal Financial Institutions Examination Council (FFIEC)¹² which has adopted the CAMELS rating system for those insured depository institutions whose primary federal supervisory agency is represented on the FFIEC¹³. Under CAMELS, the supervisory agency, such as the FDIC, assigns each institution an overall composite rating based on the agency's evaluation of six components areas, which also are rated individually.

The component ratings reflect an institution's **C**apital adequacy, **A**sset quality, **M**anagement capabilities, **E**arnings sufficiency, **L**iquidity position, and **S**ensitivity to market risk (and thus are referred to as **CAMELS** ratings). As explained in UFIRS:

The composite and component ratings are assigned on a 1 to 5 numerical scale. A 1 indicates the strongest performance and management practices and the lowest degree of supervisory concern. A 5 indicates the weakest performance and management practices and the highest degree of supervisory concern.

Each component rating is based on a qualitative analysis of certain related factors. A bank's composite rating generally has a close relationship to the individual component ratings. Examiners do not, however, simply assign composite rating by averaging the individual component ratings. In addition, examiners may give more weight to some components than to others, depending on the perceived risk at a given institution. For example, the Manual, Section 4.1, *Management*, explains:

A bank's performance with respect to asset quality and diversification, capital adequacy, earnings performance and trends, liquidity and funds management, and sensitivity to fluctuations in market interest rates is, to a very significant extent, a result of decisions made by the bank's directors and officers. Consequently, findings and conclusions in regard to the other five elements of the CAMELS rating system are often major determinants of the management rating.

Large Bank Supervision and the FDIC's Continuous Examination Process

For most institutions under the FDIC's supervision, such as community banks, full-scope examinations are performed at a point in time. For such institutions, examiners plan the examination, conduct examination procedures, assign CAMELS ratings, and communicate findings. At the conclusion of this process, a Report of Examination (ROE) is issued to the institution.

¹² FFIEC is a formal interagency body empowered, among other things, to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the FDIC, the National Credit Union Administration, the Office of the Comptroller of the Currency (OCC), and the Consumer Financial Protection Bureau (CFPB).

¹³ The FDIC Board approved the updated Uniform Financial Institutions Rating System developed through the FFIEC as a policy statement of the FDIC on December 20, 1996, and it became effective on January 1, 1997.

Alternatively, for certain institutions that are larger, more complex, or present a higher risk profile—such as First Republic—the FDIC performs full-scope examinations continuously over the course of a year. This is known as the Continuous Examination Process (CEP). For continuous examinations, the planning phase describes the types of supervisory activities to be performed and evaluation of the CAMELS components over the year. The FDIC uses a risk-based approach when producing supervisory plans. The purpose of supervisory planning is to develop an efficient, risk-focused examination strategy that is tailored to the institution's business model, risk profile, and complexity. The CEP includes onsite target reviews of areas the examiner determines necessary to complete a full-scope examination. The CEP also includes ongoing monitoring (OGM), conducted quarterly, and assessment of the institution's risks, policies, procedures, and financial condition as well as frequent communication with institution management. The Manual also explains that a dedicated Examiner-In-Charge (EIC) oversees the CEP and may be supported by additional dedicated examination staff and other staff depending on the size, complexity, and risk profile of the institution.

The FDIC issues supervisory letters (SLs) to the institution's board and management after each target review that convey the findings and can include supervisory recommendations (SRs) when appropriate. Other written communications to the institution's management may be issued based on OGM activities or other intervening supervisory events. The ROE is addressed to the institution and aggregates and summarizes findings from examination and other supervisory activities performed throughout the cycle. It also assigns the CAMELS ratings.

Supervisory Actions

The FDIC employs various supervisory actions with respect to an institution under its supervision. SRs are FDIC communications with an institution intended to inform the bank of the FDIC's views about changes needed in its practices, operations, or financial condition. When the institution has more material issues and the FDIC issues recommendations¹⁴ that require the attention of the institution's board of directors and senior management, examiners communicate using Matters Requiring Board Attention (MRBAs), which are considered to be a subset of SRs¹⁵. MRBA are intended to help the board prioritize efforts to address examiner concerns, identify emerging problems, and correct deficiencies before the bank's condition deteriorates.

In addition, the FDIC can escalate supervisory concerns by using both formal and informal enforcement actions. According to the FDIC's *Formal and Informal Enforcement Actions Manual*:

Informal actions should be used when discussions with management or findings and recommendations in the ROE will not, by themselves, accomplish the FDIC's goal of attaining timely corrective action from management. However, informal actions generally are not appropriate when an institution's problems present serious concerns and risks, in which case a formal action should be pursued.

¹⁴ According to the Manual, "It is FDIC policy to make supervisory recommendations in writing in the ROE, in a transmittal letter, or in other correspondence under official FDIC letterhead. Supervisory recommendations may not be solely verbal, but should be discussed with, and explained to bank management."

¹⁵ Although MRBAs are considered to be a subset of SRs, within this report, we count MRBAs and SRs separately.

The FDIC's informal actions include Bank Board Resolutions (BBRs) and Memoranda of Understanding (MOUs). BBRs are informal commitments adopted by an institution's board (usually at the FDIC's request) directing the institution's personnel to take corrective action regarding specific deficiencies. When the board's proposed BBR does not effectively address concerns, the FDIC may elect to pursue an MOU, which the *Formal and Informal Enforcement Actions Manual* explains is an informal agreement between the institution and the FDIC and is signed by both parties. The state regulatory agency may also be party to the MOU. In addition, the FDIC may request that an insured depository institution submit a plan to conform to safety and soundness standards under Section 39 of the FDI Act as an informal action.

The FDIC's use of an informal enforcement action does not preclude it from subsequently pursuing formal enforcement action if such formal action is legally required or if the FDIC believes the institution's management is unwilling or unable to take necessary corrective action. Formal enforcement includes such actions as the termination of federal deposit insurance, cease-and-desist orders, and civil monetary penalties.

Large Insured Depository Institution Ratings and Outlooks

For insured depository institutions with total assets of at least \$10 billion, such as First Republic, the FDIC assigns large insured depository institution (LIDI) Ratings. These ratings reflect (1) the institution's potential risk to the DIF and incorporate assessments of risk of failure assuming stressed conditions (referred to as "Vulnerability to Stress") and (2) FDIC losses assuming failure (referred to as "Loss Severity").¹⁶ Vulnerability to Stress considers both vulnerability to asset stress and vulnerability to funding stress. The FDIC also assigns LIDI Rating Outlooks (i.e. Positive, Stable, or Negative) which are projections of where the LIDI Rating appears likely to be in 12 months based on current information.

¹⁶ Ratings are from "A" through "E", where "A" rated institutions pose a low risk to the DIF under stressed conditions and "E" rated institutions are in troubled condition and pose a pronounced risk of loss to the DIF.

CAUSES OF FAILURE AND MATERIAL LOSS TO THE DEPOSIT INSURANCE FUND

This section details how the contagion effects stemming from the failure of other prominent financial institutions led to a run on deposits at First Republic, and how the deposit run exposed vulnerabilities in First Republic's business strategy. First Republic's strategy was to attract high-net-worth customers by offering very competitive loans terms, and cross-selling those customers other products and services such as demand deposits and wealth management services. This strategy resulted in a concentration in uninsured deposits. First Republic over-relied on customer loyalty to retain uninsured deposits under stressed conditions. First Republic's strategy also resulted in increased sensitivity to interest rate risk in a rising rate environment due to its significant asset/liability mismatch, and fair value declines on a portfolio of low-yielding long-duration loans.

First Republic was able to withstand the first run on deposits in March 2023. However, First Republic's subsequent quarterly earnings release on April 24 sparked a second run on deposits that it was unable to withstand, resulting in its failure on May 1 and a material loss to the DIF.

Contagion Effect Caused a Run on Deposits Exposing First Republic's Vulnerabilities

The proximate cause of First Republic's failure was contagion effect from Silvergate Bank's announcement on March 8, 2023, that it would self-liquidate, and the failure of SVB on March 10, 2023. These events caused a loss of confidence in large regional banks. During these events, mainstream and social media discussion had focused on which bank would fail next and frequently highlighted perceived similarities between SVB and First Republic.

Beginning March 10, 2023, following the failure of SVB, First Republic began to experience both steep declines in its share value and a run on deposits. First Republic was able to withstand the first run on deposits but was left in a weakened financial position. SBNY also experienced a deposit run on March 10, 2023 and was closed by regulators on March 12, 2023. Its failure further contributed towards the loss of confidence in regional banks, propagating continued deposit outflows from First Republic the week of March 13, 2023.

On March 16, a consortium of 11 banks placed \$30 billion in deposits at First Republic to help stabilize the bank and restore market confidence. First Republic developed a *2023 Go-Forward Plan* dated March 20, 2023, with the intent to stabilize and recover. On April 24, 2023, First Republic released its Q1 2023 earnings information reflecting its weakened financial position following the first deposit run, which caused a second run on deposits that First Republic was unable to withstand because it had insufficient remaining liquidity to meet continued deposit outflows. DFPI closed First Republic on May 1, 2023.

Media Attention on First Republic: Following the failure of SVB, mainstream and social media discussion had turned to which bank would be next to fail. FDIC examiners stated to Cotton that although First Republic operated under a different business model than SVB, the market perceived the institutions as similar due to First Republic's location in the same geographic market and similarities in customer bases. In addition, media outlets frequently highlighted other characteristics and associated vulnerabilities in First Republic's financial position, including:

- *Declines in the fair value of its assets:* The media noted that the difference between the book value and fair value of First Republic's assets—especially its loan portfolio—exceeded total equity resulting in “negative tangible equity”.

- **Concentration in uninsured deposits:** The media noted First Republic's high percentage of customer deposits that were uninsured and potentially 'flighty'.
- **Pressure on Net Interest Margin:** The media also discussed that First Republic's Net Interest Margin (NIM) was projected to decline due to an increased cost of funding as a result of the increasing interest rates.

Examiners told us that there were also various types of misinformation in the media regarding First Republic, including storyline elements that were seemingly sourced from articles pertaining to other troubled institutions, and sometimes inaccurately attributed to First Republic.

Other First Republic Similarities with SVB: First Republic and SVB were both headquartered in the San Francisco Bay Area in Northern California. SVB's customer base was concentrated in private equity / venture capital (PE/VC) backed technology and life sciences companies, including deposits and lending to early and late stage pre-IPO startup companies. First Republic also had strong relationships with PE/VC firms, but focused its business model on providing multiple financial service offerings to high-net-worth customers. Wealth management was one of First Republic's greatest sources of funding, and its primary loan categories were SFR, commercial real estate, and consumer lending.

As previously discussed, FDIC examiners stated that although First Republic and SVB had very different business models, their geographic proximity and interrelationships amongst their customers likely contributed to the runs on deposits experienced by First Republic. Specifically, many First Republic and SVB customers knew and communicated with each other, and the failure of SVB likely caused concern among customers about First Republic.

Capital Markets Activity: On March 8, 2023—the day Silvergate Bank announced it would self-liquidate—First Republic's share price closed at \$115.00 per share. On March 13, 2023, First Republic's share price closed at \$31.21, representing a 73 percent decrease in market value over three business days. DFPI examiners noted that significant declines in a financial institution's stock price may concern uninsured depositors and result in deposit withdrawals.

Table 2 shows First Republic's share price during that period.

Table 2: Decline in First Republic Share Values

Date	Closing Share Price	Percent Change from Prior Day
March 8, 2023	\$ 115.00	-1
March 9, 2023	96.01	-17
March 10, 2023	81.76	-15
March 13, 2023	31.21	-62

Source: Analysis of First Republic's share price information.

First Run on First Republic Deposits: First Republic experienced a run on deposits beginning March 10, 2023, following the SVB failure and negative media attention. FDIC examiners described that the run on deposits was amplified by the ease and speed by which funds can transfer with electronic banking. Additionally, according to the FDIC's Failing Bank Case for First Republic, several large money center banks¹⁷ began advising their clients to pull their funds from First Republic. March 10 deposit outflows reached approximately \$25 billion of its total

¹⁷ The National Association of Securities Dealers Automatic Quotation System defines money center banks as "banks that raise most of their funds from the domestic and international money markets, relying less on depositors for funds."

deposits of approximately \$148 billion at that time. As a result, First Republic had to draw significantly on its credit lines with the Federal Home Loan Bank¹⁸ and Federal Reserve.^{19, 20}

On Monday, March 13, 2023, withdrawal demands were significant, with approximately \$40 billion in deposit outflows. Outflows continued throughout the week at a lesser pace. On March 16, a consortium of 11 major U.S. banks placed \$30 billion in uninsured deposits at First Republic to assist in supporting the overall banking sector and stemming the contagion effect of the SVB and Signature Bank failures to the wider banking system. Despite the \$30 billion in consortium deposits, deposit withdrawals continued before stabilizing during the week ending March 24.

First Republic's financial position had significantly weakened following the deposit run because of the substantial increase in its cost of funding. Specifically, First Republic's low-cost customer deposits were significantly reduced, and replaced by higher-cost borrowings from the Federal Reserve Bank and Federal Home Loan Bank which were drawn to meet deposit outflows. First Republic prepared a *2023 Go-Forward Plan* following the initial run on deposits and shared it with FDIC examiners. The plan included certain actions to stabilize First Republic's financial position in the short-term:

- Raise \$2 billion in Tier 1 Capital to strengthen First Republic's capital position.
- Re-acquire deposits from existing clients, reduce operating expenses, and reduce the volume of new loan originations.
- Sell available-for-sale (AFS) securities and loans.
- Enhance safety and soundness by making changes to the existing Interest Rate Risk policy, drafting deposit concentration policies, maximizing the proportion of insured deposits on the balance sheet, and improving risk management.
- Increase rates on Certificates of Deposit to emphasize more stable deposits, smaller balances, and insured deposits.
- Reconstruct a more resilient balance sheet going forward with lower volatility and better duration matching between assets and liabilities.

By April 16, 2023, total deposits declined to approximately \$104 billion, of which approximately \$50 billion were uninsured, including the \$30 billion of consortium deposits. First Republic's customers had withdrawn about \$102 billion since the fourth quarter of 2022. This translated to a 58 percent decline in deposits, almost all of which were uninsured.

Second Run on First Republic Deposits: On April 24, 2023, First Republic reported its financial results from the first quarter of 2023, which reflected the financial impact of the March 2023 deposit run on First Republic. The earnings release triggered another significant decline in First Republic's stock price, and resumption of net deposit outflows totaling more than \$11 billion through 5pm ET on Friday, April 28, 2023.

As of April 26, 2023, a First Republic's internal balance sheet showed total assets of about \$228.1 billion and total deposits of about \$98.4 billion, including the \$30 billion in deposits

¹⁸ <https://www.fdic.gov/resources/bankers/affordable-mortgage-lending-center/guide/part-3-docs/advances.pdf>

¹⁹ <https://www.frbdiscountwindow.org/Pages/General-Information/The-Discount-Window>

²⁰ <https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20230312a1.pdf>

placed by a consortium of 11 banks. The Federal Reserve Bank of San Francisco restricted future Discount Window²¹ borrowings to overnight terms.

On April 29, 2023, the Federal Reserve Bank of San Francisco reclassified First Republic's borrowing status to Secondary Credit²² and advised the FDIC that adjustments made to collateral values had eliminated any additional borrowing capacity that had existed. Combined with continued outflows, the low level of on-balance sheet liquidity, the short term nature of current funding sources, and the lack of additional borrowing capacity rendered First Republic's liquidity position critically deficient.

On May 1, 2023, the DFPI closed First Republic and appointed the FDIC as receiver. On the same day, the FDIC announced that it was entering into a purchase and assumption agreement with JPMorgan Chase Bank, National Association, Columbus, Ohio, to assume all of the deposits and substantially all of the assets of First Republic.

Business Strategy Increased Susceptibility to Contagion Risk and Prevented Recovery

First Republic Bank was formed in 1985, and followed a business model that remained largely unchanged for 37 years as it weathered numerous market cycles, including the global financial crisis in 2008. However, as shown above in **Figure 1**, the interest rate environment in which First Republic thrived from 1985 through 2021 was comprised mostly of successive decreases in the effective federal funds rate followed by a prolonged period of historically low rates. When interest rates began to rise sharply in 2022, with further rate increases expected, First Republic failed to effectively manage the related risk.

Background of First Republic's Business Strategy: Per First Republic's 2022 Business Plan, management was historically committed to a simple, client-focused, financial services business model. First Republic's core businesses included SFR lending, private banking, business banking, wealth management, trust, and brokerage services focused on high-net-worth customers. Geographically, it focused on urban coastal markets with dense populations and targeted urban professionals as its core client base.

First Republic's 2022 Business Plan stated:

Our business model is very simple, by design. We focus on a few things and strive to do them very well. We seek to get trial, get trial, get trial, and then earn lifelong clients with our extraordinary service. Since inception, our lead loan product has been the single-family home loan—a proven, safe asset class that, coupled with our service, provides a perfect opportunity to get trial and subsequently the full banking relationship (i.e., deposits, wealth management, business banking). Regardless of the entry point to the bank, our goal is for the banker or advisor to deliver the entire bank to their clients, bringing in partners when appropriate.

²¹ The Discount Window refers to Federal Reserve lending to depository institutions to help them manage liquidity risks. Depository institutions have access to discount window credit from their regional Federal Reserve Bank. Discount window loans need to be collateralized to the satisfaction of the lending Reserve Bank.

²² Secondary credit is a lending program that is available to depository institutions that are not eligible for primary credit. It is extended on a very short-term basis, typically overnight, at a higher rate than the primary credit rate.

Relationship-Based Pricing: First Republic employed a relationship-based pricing model for its products and services. DFPI officials told us that First Republic assessed pricing and profitability holistically by customer, rather than at an individual product level. First Republic would negotiate rates individually with its customers based on its ability to cross-sell services. For example, a customer who used First Republic's wealth management services generated fee revenue, and therefore, may have received more attractive rates on loans and/or deposits. First Republic's 2022 Business Plan discussed its relationship-based pricing model as follows:

The goal, as always, is to remain competitive on loan pricing for the best existing and new clients with a focus on building long-term relationships with clients without giving up yield unnecessarily. A renewed focus on relationship pricing and bringing over as much of the relationship as possible, deposits in particular, will be important to driving low-cost funding while ensuring that [we] maximize opportunities for our clients to experience our high service levels and win the right to be their lead bank. In the near-term, the environment will predicate lower net interest margin driven by higher cost of funding.

Some of First Republic's customers committed to keep minimum deposit levels at First Republic to participate in the relationship-based pricing on certain loans and other products. For the majority of mortgage loans, clients received lower rates based on deposits or wealth management assets held at First Republic. However, more than \$9 billion in deposits that had been committed were withdrawn by customers during the run on deposits.

Focus on Funding Growth with Low-Cost Deposits: First Republic experienced significant growth in the years leading up to its failure, exceeding the average growth of peer banks. From 2019 through 2022, First Republic's total assets grew by 21 percent annually. In comparison, the total assets of banks within First Republic's peer group during the same timeframe grew by only 11 percent annually. During 2022, First Republic's total assets grew by 17 percent, when peer banks' total assets grew by 3 percent on average.

Table 3 details the composition of First Republic's liabilities as of December 31, 2022. Consistent with First Republic's strategy of funding its growth through gathering low-cost deposits, First Republic's liabilities were comprised primarily of demand deposits, including non-interest bearing checking accounts as well as checking accounts and money markets with low interest rates. Seventy-seven percent (77%) of First Republic's liabilities were comprised of demand deposits as of December 31, 2022.

Table 3: Composition of the Liabilities

As of December 31, 2022 (\$s in Millions)		
Account	Amount	Percent of Total Liabilities
Deposits:		
Noninterest-bearing checking	\$ 62,579	32
Interest-bearing checking	41,178	21
Money market checking	25,805	13
Money market savings and passbooks	21,663	11
Total Demand Deposits	151,225	77
Certificates of deposit	25,212	13
Total Deposits	176,437	90
Short-term FHLB advances	6,700	3
Long-term FHLB advances	7,300	4
Senior Notes	500	0
Subordinated notes	779	0
Other liabilities	3,477	2
Total Liabilities	\$ 195,193	100

Source: First Republic's December 31, 2022, Form 10-K filing with the U.S. Securities and Exchange Commission (SEC).

Funding Sources and Concentrations: First Republic's business strategy resulted in a long-standing funding concentration in uninsured deposits. Amongst banks with more than \$100 billion in assets, First Republic ranked 4th highest of 34 banks²³ in its percentage concentration in uninsured deposits. **Table 4** summarizes First Republic's uninsured deposits as a percentage of total deposits for each of the last five years, prior to the initial deposit run. As communicated in FDIC guidance, uninsured deposits inherently present a higher risk to banks during times of actual or perceived stress. Specifically, depositors are more likely to withdraw uninsured deposits given they exceed the FDIC's \$250,000 insurance limit, which is statutorily-defined.

Table 4: Concentration in Uninsured Deposits

Call Report Date	Estimated Uninsured Deposits	Total Deposits	Uninsured Deposits as a Percent of Total Deposits
12/31/2022	119,470,758	176,436,706	68
12/31/2021	116,696,693	156,321,243	75
12/31/2020	80,302,900	114,928,800	70
12/31/2019	59,008,164	90,133,246	66
12/31/2018	51,655,376	79,063,236	65

Source: First Republic's *Consolidated Reports of Condition and Income* (Call Reports).

As shown, uninsured deposits comprised 68 percent of First Republic's total deposits as of December 31, 2022. After the first run on deposits, uninsured deposits decreased to 28 percent of total deposits, excluding the \$30 billion deposited by the consortium of banks intending to restore market confidence. Accordingly, the majority of customers' withdrawals during the first run on deposits were uninsured deposits, which proved to be volatile when First Republic came under stress.

²³ The peer group comparison was determined using uninsured deposit data provided by FDIC. In line with the Call Reports, the uninsured deposits totals only include uninsured domestic deposits. Uninsured foreign deposits were not included in the information provided by FDIC or considered in this analysis.

As of September 30, 2022, First Republic's top ten depositors accounted for only 3.83 percent of its total deposits. Although First Republic had a greater percentage of uninsured deposits than a majority of peer banks – unlike SBNY and SVB – First Republic's uninsured deposits were not concentrated amongst a small group of customers with large balances.

Asset Composition and Concentrations: First Republic's assets was primarily comprised of loans and debt securities. **Table 5** demonstrates the composition of First Republic's assets as of December 31, 2022.

Table 5: Composition of the Assets

As of December 31, 2022 (\$s in Millions)		
Account	Amount	Percent of Total Assets
Cash and cash equivalents	\$ 4,283	2
Debt securities available-for-sale (presented at fair value and no allowance for credit loss)	3,347	2
Debt securities held-to-maturity (presented at amortized costs, net of allowance for credit losses of \$11)	28,348	13
Equity securities	24	0
Loans		
Single Family Residential Real Estate	98,768	46
Other Residential Real Estate	3,992	2
Multifamily Income property	21,588	10
Other Income Property	12,969	6
Business	18,793	9
Other	10,758	5
Total loans held for investment	166,868	78
Less: Allowance for credit losses	(784)	0
Loans, net	166,084	78
Other assets	10,553	5
Total Assets	\$ 212,639	100

Source: First Republic's December 31, 2022, Form 10-K filing with the U.S. Securities and Exchange Commission (SEC).

As shown above, 78 percent of First Republic's total assets were loans, with a concentration in SFR loans. As part of its SFR portfolio, First Republic issued nonconforming jumbo mortgages with an initial interest-only repayment period of generally ten years, and then even amortization until maturity. As of December 31, 2022 and 2021, loans with an initial interest-only repayment period made up 61 and 59 percent of First Republic's SFR loans, respectively. As previously discussed, First Republic used these products to attract high-net-worth customers and expand the banking relationship by providing trust and wealth management services, among other personalized banking products.

Management's Commitment to its Long-Standing Business Strategy, even as the Interest Rate Environment Changed: First Republic maintained its long-standing business strategy, even as interest rates began to rise early in 2022. As previously described, Bank management expected rising rates to compress its NIM, but maintained its strategy with the perspective that the interest rate environment is cyclical, and believed it would weather this market cycle as it had weathered previous market cycles.

First Republic's NIM during 2022 was compressed by customers' shifts from non-interest bearing checking accounts towards time/certificate of deposit accounts in response to the rising interest rate environment. Based on First Republic's *Uniform Bank Performance Reports* (UBPR), time deposits increased from \$7.4 billion at December 31, 2021, to \$25.2 billion as of December 31, 2022. As a result, First Republic's cost of funding increased, including an increase in interest paid on domestic deposits from \$95 million in 2021 to \$654 million in 2022.

First Republic was unable to weather the aggressive increases in interest rates. The FDIC stated in a letter to First Republic dated April 28, 2023, "the decision to operate with a significant asset/liability mismatch during a period of rising interest rates in 2022, and continuing, has severely impaired the institution's ability to restructure its balance sheet".

Asset Liability Mismatch Exceeded Peer Banks and First Republic's Risk Appetite

First Republic operated with an asset/liability mismatch that exceeded a majority of peer banks and increased its susceptibility to interest rate risk in a rising rate environment. This mismatch was inconsistent with First Republic's own policies and its risk appetite thresholds. Nevertheless, First Republic accepted the risk without taking sufficient corrective action. Following the deposit runs, the mismatch contributed towards First Republic's inability to recover.

As of December 31, 2022, First Republic had a ratio of net loans and leases to assets of 78 percent while the peer group average was only 51 percent. Additionally, First Republic's ratio of net loans and leases to deposits was 94 percent compared to the peer group average of 62 percent. In both of these metrics, First Republic was in the 96th percentile of its peer group.

First Republic's Interest Rate / Market Risk Management Framework: First Republic's policy for managing interest rate and market risk was defined in its *Interest Rate / Market Risk Management Framework*. **Table 6** includes selected excerpts from the policy:

Table 6: First Republic Interest Rate / Market Risk Management Framework

Framework Component	Principle	Implication
Risk Appetite Framework	<i>We strive to maintain a neutral balance sheet.</i>	<i>We regularly analyze the sensitivity of our net interest income ("NII") and economic value of equity ("EVE") to changes in interest rates to limit the potential negative impact of market downturns and periods of interest rate volatility, both in the short-term and in the long-term.</i>
Strategic Planning	<i>We aim to maintain a balanced match of assets to liability that limits the volatility of earnings and capital stemming from changes in interest rates and market conditions.</i>	<i>We manage interest rate risk as set by the direction of the bank's Business Plan and to ensure there are few, if any, deviations from the Business Plan forecasts. This is done primarily by originating and retaining adjustable-rate loans and hybrid ARM [Adjustable-Rate Mortgage] loans with initial short- or intermediate-term fixed rates, and match funding these assets with checking and savings deposits; short- and intermediate- term CDs; long-term, laddered maturity, fixed-rate FHLB advances; and unsecured, term, fixed-rate senior notes...</i>
Risk Measurement	<i>We measure and manage the potential impact of changes in interest rates on our net interest income (NII), net interest margin (NIM), and capital.</i>	<i>We conduct scenario simulations of changes in interest rates and yield curves. We use a simulation model to measure and evaluate potential changes in our contractual NII, which excludes the impact of purchase accounting. We run various hypothetical interest rate scenarios at least quarterly and compare these results to a scenario with no changes in interest rates.</i>
Sensitivity Analysis Limits	N/A	<i>There are policy limits in place for the outputs of the stress test results for changes to NII and EVE. Board approved interest rate risk limits that reflect the risk tolerance and business activities of are used to monitor and manage interest rate risk. The limits cover rate shock and ramp scenarios which enables to accurately assess the impact of optionality to the balance sheet.</i>

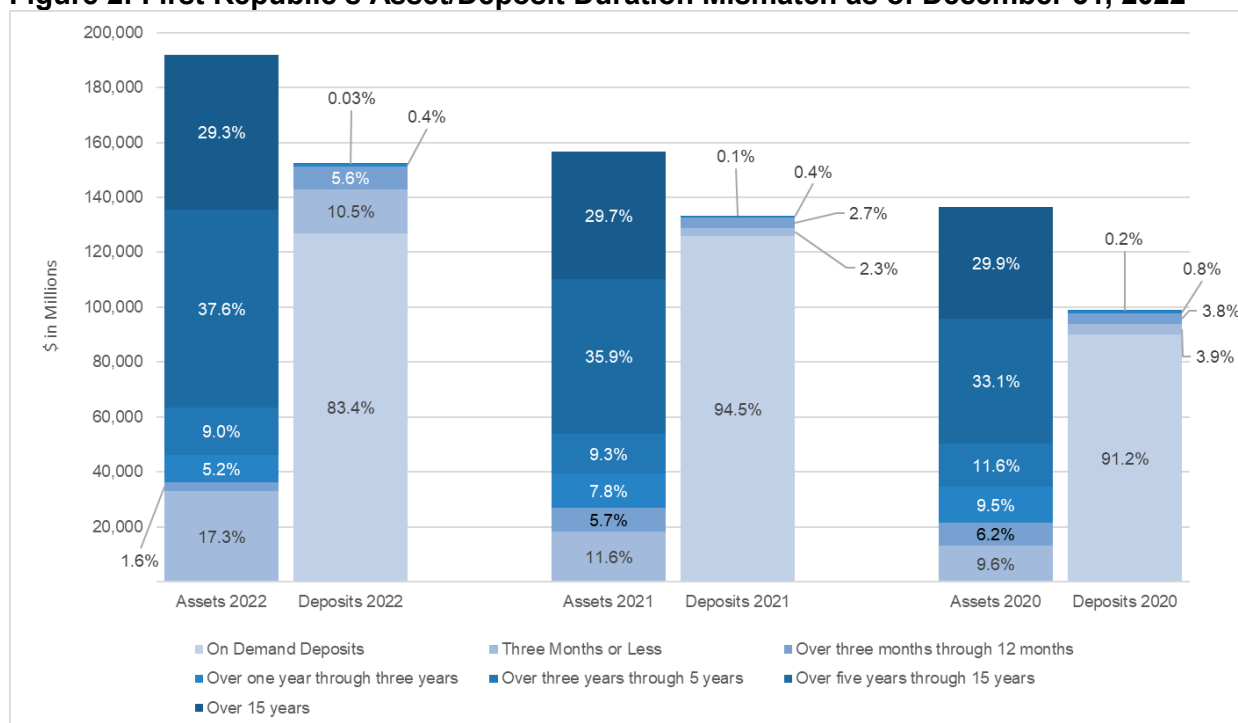
Source: The FDIC's examination documentation for First Republic.

As shown, First Republic's policy included maintaining a balanced match of assets and liabilities, including issuance of adjustable-rate loans and match funding those with liabilities. The policy also included First Republic's Board of Directors approving and monitoring interest rate risk limits, including First Republic's EVE.

Duration Mismatches Inconsistent with First Republic's Framework: First Republic had an asset/liability mismatch that was inconsistent with its *Interest Rate / Market Risk Management Framework*. As previously discussed, First Republic's policy stated that it aimed to maintain a balanced match of assets and liabilities to limit the volatility of earnings and capital stemming from changes in interest rates and market conditions.

Figure 2 below compares the duration of First Republic's assets (primarily long-term loans and debt securities) and liabilities (primarily demand deposits). As displayed, of First Republic's deposits, 99.5 percent had a duration of one year or less; whereas, 18.9 percent of its loans and securities had a duration of one year or less.

Figure 2: First Republic's Asset/Deposit Duration Mismatch as of December 31, 2022

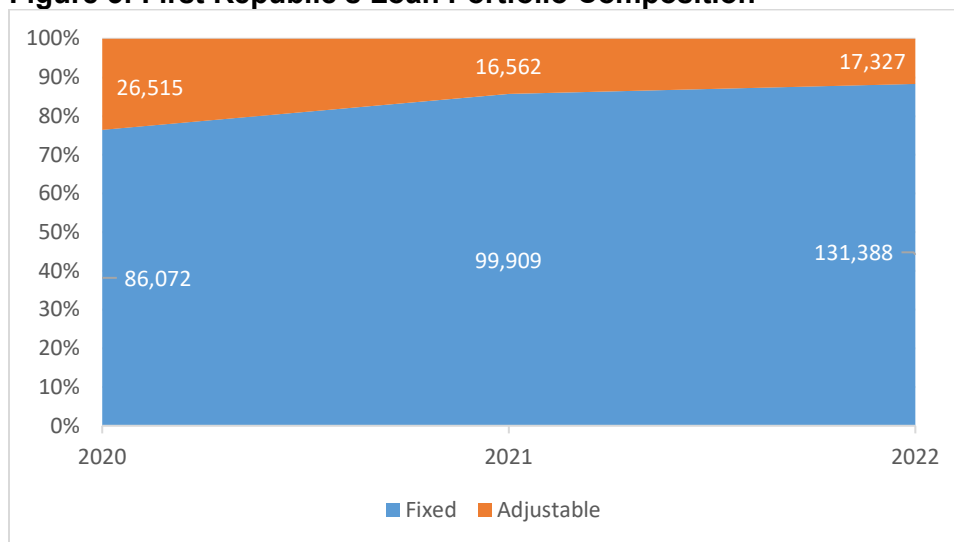


Source: Based on First Republic's *Consolidated Reports of Condition and Income* (Call Reports) for the periods ending December 31, 2022, 2021, and 2020.

First Republic's sensitivity to interest rate risk in a rising rate environment was exacerbated by a shift in the composition of its loan portfolio during a historically low interest rate environment.

Figure 3 displays that fixed-rate loans increased as a percentage of First Republic's loan portfolio from December 31, 2020 to December 31, 2022.

Figure 3: First Republic's Loan Portfolio Composition



Source: First Republic's Form 10-K filings with the U.S. Securities and Exchange Commission for the years ended December 31, 2020, 2021, and 2022.

As shown previously, First Republic's *Interest Rate / Market Risk Management Framework* included that it managed interest rate risk by originating and retaining adjustable-rate loans and hybrid ARM loans with initial short- or intermediate-term fixed rates, and match funding these assets liabilities. However, FDIC examiners documented that borrowers began moving towards longer-term loans during the low interest rate environment. Specifically, the FDIC's Q4 2022 OGM Report describes that, "In 2016, borrowers started shifting their loan maturities from 5/1 ARMs to longer term maturities. By December 2021, 30-year fixed rate loans and 10/1 hybrids were 75% of new SFR volume. In Q3 2022, 30-year fixed rate loans and 10/1 hybrids were 66% of new SFR volume."

First Republic's Risk Appetite Breaches for its Economic Value of Equity: As previously discussed, First Republic periodically measured NII and EVE metrics to monitor compliance with its *Interest Rate / Market Risk Management Framework*. The Bank identified a decrease in its EVE based on its Q1 2022 analysis. Then, it identified risk-appetite statement (RAS) breaches in Q2, Q3, and Q4, and expected continued breaches for several more quarters. The EVE metric breaches were caused by the increasing interest rate environment and First Republic's significant asset/liability duration mismatch. First Republic chose to continue monitoring the breaches rather than take corrective action, believing that their ample liquidity position would allow them to navigate the interest rate cycle.

The Manual explains various interest rate risk measurement methods. Regarding economic value of equity, it states:

Economic value methodologies attempt to estimate the changes in a bank's economic value of capital caused by changes in interest rates. A bank's economic value of equity represents the present value of the expected cash flows on assets minus the present value of the expected cash flows on liabilities, plus or minus the present value of the expected cash flows on off-balance sheet instruments. Typically, an EVE [Economic Value of Equity] model projects the value of a bank's economic capital for a base-case scenario, and then compares it to a stress scenario. These models go by various names and acronyms, such as EVE, MVE (Market Value of Equity), or NPV (Net Present Value).

Beginning April 2022, First Republic periodically discussed that, without growth, its equity was liability sensitive, and that options to consider in the future would be shortening the duration of assets or extending the duration of liabilities. However, Bank management chose to continue monitoring its risk-appetite breaches rather than take corrective action, believing that continued growth and its strong liquidity position would allow it to navigate a difficult interest rate environment. First Republic's meeting minutes provided to FDIC examiners document the following:

- April 26, 2022: The Asset/Liability Management (ALM) committee discussed a decrease in its Q1 2022 EVE due to declines in asset prices outpacing declines in liabilities costs. First Republic's Vice President and Head of the ALM Committee suggested that First Republic stop lengthening its asset duration considering the increasing likelihood of interest rates moving higher this year [2022]. No further action was taken.
- August 1, 2022: The ALM committee discussed that EVE decreased [as of Q2 2022] primarily due to declines in asset prices – a result of increased market rates, widening spreads, and rate volatility. Asset duration continued to expand, and liability duration contracted due to market changes and the funding mix shifting to shorter duration

deposits and advances. As a result, the duration of equity is liability sensitive, and the EVE risk profile breaches most thresholds.

Bank officials discussed that without growth, First Republic is firmly liability sensitive, and that the extension of asset duration has been highlighted at the ALM committee for quite some time as First Republic has shifted originations from shorter duration fixed and variable rate hybrid loans to 30 year fixed-rate and loan sales have substantially declined. In addition, the officials discussed that deposits were pushing EVE further to be liability sensitive as balances migrate from checking to higher-yielding and shorter-duration products. With future rate increases planned and expectations that funding duration would continue to shorten, the officials discussed that the EVE risk profile is likely to stay liability sensitive and possibly deteriorate further in the short term.

Bank officials also discussed that First Republic's mortgage rates were decreasing to maintain market share even though the Federal Reserve planned for more interest rate increases.

No further action was taken.

- September 7, 2022: The Directors' Enterprise Risk Management (DERM) committee discussed the new EVE risk appetite breach as of Q2 2022, noting Enterprise Risk Management's recommendation to continue monitoring for the next 1-2 quarters and reevaluate the measurement metrics including duration of assets/liabilities.
- September 14, 2022: The Board of Directors approved the RAS metric breach. No corrective action was noted.
- October 26, 2022: Following another RAS breach for EVE for as of Q3 2022, the head of the ALM committee wrote a memorandum to the Board of Directors stating that the EVE analysis, which does not consider new business, is materially liability-sensitive. This was primarily due to lower asset values due to higher rates and widening spreads and a relatively steady asset duration that is more than offset by ongoing liability duration declines. The memorandum noted that EVE Risk Tolerance and Risk Appetite thresholds were breached in all scenarios. The memorandum also states that ALM underwent a comprehensive Market and Funding Risk exam by the FDIC and DFPI in Q3 2022, and that the exam concluded with no supervisory recommendations.
- November 11, 2022: The DERM committee discussed the Q3 2022 RAS metric breach regarding EVE, noting that the current economic environment would likely mean a continued breach for several quarters in the rising interest rate environment.
- November 16, 2022: The Board of Directors approved the RAS metric breach. No corrective action was noted.
- February 1, 2023: In the ALM meeting materials, there were EVE risk appetite and risk tolerance breaches across all scenarios. There were also breaches identified in NII simulations.

After the first run on deposits, First Republic's significant asset/liability mismatch limited its options for restructuring its balance sheet. In testimony before the House of Representatives, the FDIC Chairman said the following about First Republic's asset/liability mismatch and how it affected First Republic:

While First Republic Bank was initially able to manage liquidity to meet withdrawal requests, management's strategic decision to retain a long-standing business model with a significant asset/liability mismatch during a period of rising interest rates contributed to

a loss of confidence in the bank on the part of depositors, and, ultimately constrained options for the bank to restructure its balance sheet, sell assets, or raise capital.

Declines in Fair Values Impaired Capital and Liquidity

First Republic experienced significant declines in the fair value of its assets resulting from the rising interest rate environment beginning in 2022. Although industry-wide banks experienced similar valuation changes, First Republic was especially sensitive to increasing interest rates due to its concentrations in long-duration low-yielding assets, and failure to sufficiently mitigate the resulting risk from rising interest rates.

First Republic's estimated fair value declines contributed towards the loss in confidence in First Republic that sparked the run on deposits. Following the deposit runs, the fair value declines impaired First Republic's liquidity options due to the impact that the realization of losses from any sale of the assets would have on its Capital. This ultimately contributed towards First Republic's inability to recover. **Table 7** below shows a comparison of the book value and fair value of First Republic's assets as of December 31, 2022.

Table 7: Comparison of Book Value to Fair Value of Assets

As of December 31, 2022 (\$s in Millions)			
Asset Type	Book Value	Fair Value	Fair Value Gain (Loss)
Loans (Net)	\$ 166,084	\$ 143,925	\$ (22,159)
AFS Securities	3,817	3,347	(471)
HTM Securities	28,359	23,587	(4,839)
Total	\$ 198,260	\$ 170,859	\$ (27,469)
As of December 31, 2021 (\$s in Millions)			
Asset Type	Book Value	Fair Value	Fair Value Gain (Loss)
Loans (Net)	\$ 134,262	\$ 129,269	\$ (4,993)
AFS Securities	3,425	3,381	(44)
HTM Securities	22,301	23,422	1,121
Total	\$ 159,988	\$ 156,072	\$ (3,916)

Source: First Republic's 2022 and 2021 Form 10-K filings with the U.S. Securities and Exchange Commission.

As shown, the fair value of the First Republic's loans and securities was \$27.5 billion less than its book value as of December 31, 2022. This fair value deficit grew by \$23.6 billion since December 31, 2021. As of December 31, 2022, First Republic's total equity recorded on its balance sheet was \$17.4 billion, which was \$10.1 billion less than the fair value deficit displayed in **Table 7** above.

After the initial run on deposits during March 2023, First Republic first attempted to attract capital before beginning to liquidate its assets. In its *2023 Go-Forward Plan*, First Republic stated:

We anticipate selling loans and available for sale securities during Q2 2023. While we will look to sell assets trading close to par in the near future, including some AFS securities, we must be cognizant of recent events at other banks and ensure that we

have raised capital in advance of any material sales that would lead to material realized losses.

First Republic's plan was unsuccessful and it was unable to recover. A letter from the FDIC to First Republic dated April 28, 2023, stated "the bank has not been successful at selling any assets due to the market value of loans and securities being well below book values and the resultant losses contained within those assets that would deplete existing capital resources in a market sale."

Overreliance on Customer Loyalty to Retain Uninsured Deposits

First Republic used several strategies considered by FDIC examiners to be 'tried and true' to increase the durability, or 'stickiness', of its customer relationships and retention of their deposit accounts and uninsured deposit amounts. However, these strategies proved ineffective at retaining uninsured deposits, which left First Republic at an unexpected velocity and magnitude, when First Republic experienced a stress event. Deposit outflows exceeded First Republic's expectations across its most aggressive and worst case stress testing scenarios, as well as its available liquidity.

First Republic's Strategy for Increasing the Durability of Customer Deposits: First Republic sought to increase the durability, or 'stickiness', of customer deposits in various ways. First Republic sought to attract and retain customer relationships, including their deposits, by providing relationship-focused client services. It identified its Net Promoter Score (NPS)²⁴—customer loyalty measure—as one of its most important metrics. In 2022, its NPS was 79 (up from 73 in 2021), which was 2.3 times the U.S. banking industry average of 34. First Republic assessed that 85 percent of clients said that the relationship with their banker or wealth manager was the most or one of the most important reasons they did business with First Republic. The Bank historically also had a very low client attrition rate, which was only 1 percent in 2022 and 2 percent in 2021.

Additionally, First Republic sought to build a 'full banking relationship' with its customers (i.e., by offering deposits, wealth management, real estate lending, business banking services to the same customer). In an internal memorandum dated March 9, 2023, the FDIC assessed the potential contagion risk to First Republic from the SVB deposit run. The memorandum stated:

...a large portion [of deposits] are uninsured which remains a notable risk. Management mitigates this risk by developing and building strong client relationships that typically involve multiple product and service offerings that tend to reduce the portability of the deposit accounts. Stability characteristics include average account tenure of 8 years, 9 products and services per relationship, and 41 percent having loans and/or wealth management accounts.

In its 2022 Business Plan, First Republic stated, "Real estate lending activities have historically led to long term, stable clients, the Bank will continue to focus on developing a holistic deposit relationship with these clients over time". This belief was reiterated by Bank management after the initial run on deposits in its *2023 Go-Forward Plan*, which states "for the majority of mortgage loans, clients received lower rates based on deposits or wealth management assets

²⁴ The Net Promoter Score (NPS) measures the loyalty of customers to a company with a single-question customer survey.

held at the Bank. We anticipate working with these clients to see if they will move the deposits back [to the bank] as stability further increases.”

First Republic’s Stress Testing Scenarios Underestimated Potential Outflows of Uninsured Deposits: First Republic’s Liquidity Risk Management Framework stated:

Liquidity Stress Testing at First Republic Bank is performed at least quarterly, and is an integral component of both the overall Liquidity Risk Management Policy and the Contingency Funding Plan... The intent of the stress testing framework is to provide output that is clear, actionable, well-supported, and which can support informed decision making. Additionally, the results of the liquidity stress test are used as an input to the Bank’s process for targeting on-balance sheet primary liquidity.

The Liquidity Risk Management Framework included five scenarios which First Republic periodically assessed as part of Liquidity Stress Testing. **Table 8** shows First Republic’s estimated deposit outflows under each scenario as of September 30, 2022; and the actual outflows that occurred in 2023 (net of the \$30 billion in deposits from a consortium of 11 banks).

Table 8: First Republic Stress Testing Scenarios and Realized Events

Cumulative Outflows in millions	1 Day	14 Days	30 Days	90 Days	180 Days	360 Days
First Republic Stress Testing Scenarios – Bank Estimates as of September 30, 2022						
Realistic Worst Case	\$8,030	\$20,200	\$22,650	\$24,090	\$23,910	\$17,840
Systemic Credit and Funding Stress	8,030	20,200	22,650	24,090	21,650	15,960
Below Well Capitalized	20,540	21,460	21,990	29,600	28,090	26,360
Rise in Interest Rates	13,520	14,330	16,100	25,220	14,920	19,120
Earthquake	5,440	6,260	6,660	10,940	9,770	-17,400
Actual Realized Net Deposit Outflows						
March 10 – April 28 2023	\$27,690	\$ 103,573	\$103,090	\$116,114*	-	-

*Note that the amount presented is from April 28, 2023, on day 49 of the outflows.

Source: Comparison of actual realized outflows (derived from daily deposit updates) and First Republic’s anticipated outflows (from the most recent liquidity management update on September 30, 2022).

The table demonstrates that the actual deposit outflows realized by First Republic in March-April 2023 were unexpected in velocity and magnitude and significantly exceeded First Republic’s stress testing estimates across every scenario. As previously discussed, the majority of First Republic’s deposit outflows were uninsured deposits. Accordingly, First Republic’s stress testing assumptions overestimated the stickiness of uninsured deposits, and underestimated the uninsured deposit outflows in a stress event.

THE FDIC’S SUPERVISION OF FIRST REPUBLIC BANK

Recent Supervisory History

First Republic was part of the FDIC’s LBS program, and was subject to continuous examination procedures that included preparation of supervisory plans for each examination cycle. Each supervisory plan included FDIC’s assessment of First Republic’s risks, planned target reviews, and OGM activities. The FDIC also performed quarterly LIDI reporting and issued annual roll-up ROEs. Cotton found that FDIC’s planned target reviews aligned to its risk assessments, and that FDIC examiners performed planned target reviews, OGM reports, and ROEs completely

and within established timeframes. Based on the results of its supervision, the FDIC and the DFPI assessed First Republic's composite and component CAMELS ratings as shown in the table below:

Table 9: First Republic's Historical CAMELS Ratings

Rating Type	2018	2019	2020	2021	2022	3/31/23*	4/28/23*
Capital Adequacy	2	2	2	2	2	3	4
Asset Quality	1	1	1	1	1	2	3
Management	1	1	1	1	1	3	4
Earnings	2	2	2	2	2	3	4
Liquidity	2	2	2	1	1	4	5
Sensitivity to Market Risk	2	2	2	2	2	4	5
Composite	2	2	2	2	2	3	5

Source: The FDIC's examination documentation for First Republic.

*The FDIC issued interim CAMELS rating downgrades following the first and second deposit runs. The interim downgrades are further discussed below.

Appendix III lists target reviews performed in the 2018 through 2022 examination cycles, and resulting supervisory recommendations or MRBAs (when applicable).

Supervisory Recommendations, MRBAs, and Enforcement Actions

The FDIC did not have any open supervisory recommendations, MRBAs, or enforcement actions related to the causes of First Republic's failure prior to the first run on deposits beginning March 10, 2023.

Supervisory Recommendations: At the time of First Republic's failure, the FDIC had two open supervisory recommendations unrelated to the causes for failure. The recommendations are presented in **Appendix III**, and were identified in the 2022 examination cycle, Market and Funding Risk target review. Both recommendations were identified as corrected by First Republic Management, and pending FDIC review.

MRBAs: At the time of First Republic's first deposit run, there were two open MRBAs unrelated to the causes for failure. The MRBAs pertained to First Republic's compliance program and compliance management system. Both MRBAs were identified as corrected by Bank management, pending FDIC review.

Enforcement Actions: The FDIC did not take any enforcement actions related to First Republic.

Interim CAMELS Ratings Downgrades and MRBAs Following Deposit Runs

As discussed in the *Causes of Failure* section above, First Republic began experiencing a run on deposits beginning March 10, 2023. As shown in **Table 9** above, the FDIC assessed First Republic's CAMELS ratings at 211212/2 from 2022 until after the first run on deposits.

Following the first run on deposits, the FDIC issued an interim CAMELS rating downgrade to 323344/3 and MRBAs on March 31, 2023. The MRBAs state:

Recent financial market disruptions have exposed weaknesses in the institution's risk management processes. These weaknesses raise concerns regarding the institution's ability to meet its ongoing funding needs under current market conditions. While First Republic Bank developed a 2023 Go-Forward Plan that identifies strategic actions

executive management is taking to reestablish long-term sustainable operations, the institution's business model now relies heavily on debt and other noncore funding sources to support a low yielding, long duration portfolio. As a result, the institution's earnings have been materially impacted and, if not reversed, could adversely impact capital. Also, immediate action is required to strengthen the institution's liquidity and financial position. Therefore, the FDIC and DFPI are issuing the below Matters Requiring Board Attention.

The Board and senior management should take all steps to implement the 2023 Go-Forward Plan, which includes, but is not limited to:

- A strategy for an orderly return to sustainable borrowing levels;*
- A viable long-term funding strategy, and*
- Satisfactory capital throughout the plan window, including the preservation of capital resources.*

The plan should continue to consider all options to restore market confidence in the institution's business model, including but not limited to:

- Raising capital;*
- Restructuring the balance sheet, including the funding profile.*
- Selling assets;*
- Selling business lines or divisions; and/or*
- Selling the entire franchise.*

The Board and senior management should also improve risk management practices and conserve cash resources as the 2023 Go-Forward Plan is being implemented, including, but not limited to:

- Developing a sound market and interest rate risk framework, including well-defined risk tolerance limits, measures to respond to changing economic and interest rate conditions, and follow-up actions required when deviations or breaches are identified and reported; and*
- Suspending payments on preferred stock to preserve capital resources.*

Following First Republic's 2023 first quarter earnings release on April 24, 2023, net deposit outflows resumed and accelerated through the close of business on April 28, 2023. The FDIC issued a second interim CAMELS rating downgrade on April 28, 2023, to 434455/5, stating:

The Board and management's efforts to restore market confidence in the bank's business model as outlined in the 2023 Go-Forward plan... have not materialized. A key element in the Plan included bringing back deposits to rebuild bank funding; however, deposit outflows resumed after your April 24, 2023 earnings call and have accelerated, totaling over \$8 billion in the three days ending April 27, 2023. This renders your plan unachievable and jeopardizes the viability of the institution. Furthermore, the decision to operate with a significant asset/liability mismatch during a period of rising interest rates in 2022, and continuing, has severely impaired the institution's ability to restructure its balance sheet. While the bank has been able to meet deposit outflows by drawing primarily on the Federal Reserve Discount Window, which reached a high of approximately \$109 billion, remaining capacity is limited and the bank cannot continue to meet obligations without significant outside assistance. Further, long-term borrowing is

no longer available, placing sole reliance on less stable overnight borrowings to fund continued deposit outflow. The bank is now structurally unprofitable, in large part due to higher cost borrowings significantly exceeding asset yields.

Efforts to raise additional capital, sell assets, and/or sell the institution have not materialized, and near-term prospects to do so are unlikely. As of the date of this letter, the bank has not been successful at selling any assets due to the market value of loans and securities being well below book values and the resultant losses contained within those assets that would deplete existing capital resources in a market sale. Further, many uncertainties remain given the significant loss of deposits, including harm to the institution's reputation given negative media coverage.

On May 1, 2023, the DFPI closed First Republic.

Missed Opportunities to Take Earlier Supervisory Actions

We conclude the FDIC missed opportunities to take earlier supervisory actions pertaining to First Republic consistent with its forward-looking supervisory approach. Specifically:

- The FDIC identified First Republic's increasing liquidity risk in 2022 Q3 and Q4, but did not take timely action to downgrade the Liquidity component rating from a '1' to a '2' prior to the first run on deposits.
- First Republic's noncompliance with its *Interest Rate / Market Risk Management Framework*, including its asset/liability mismatch and RAS breaches for three consecutive quarters in 2022 and failure by the bank to take appropriate corrective action, merited a downgrade to the Management component rating from a '1' to a '2', and an MRBA pertaining to Management and Sensitivity to Market Risk.

Due to the unexpected nature of the liquidity stress event, FDIC supervisory actions may not have prevented First Republic's failure. However, earlier supervisory action may have caused First Republic to take corrective action and possibly reduce its susceptibility to contagion risk or reduce the loss to the DIF upon failure.

The Manual explains:

Risk-focused supervision employs a forward-looking supervisory approach where control weaknesses or other risk management conditions or problems are assessed early, and when necessary, corrected, in order to prevent or mitigate serious problems to an institution's financial condition in the future.

To address minor issues identified during an examination, examiners may present suggestions to management during discussions. For more significant problems, examiners should discuss the deficiencies with management and the board of directors during the examination and at subsequent exit meetings, and address the problems in the ROE. Such discussions and written commentary should clearly convey the issue that is cause for concern and explain the risks to the institution's operations or financial performance if not addressed in a timely manner. Significant issues that require immediate attention should be identified as Matters Requiring Board Attention in the ROE. If circumstances warrant and after discussing with appropriate FDIC regional management, examiners should make recommendations for informal or formal

agreements or actions if they identify unacceptable risk levels or risk management practices, even in 1 or 2 rated institutions.

A forward-looking supervisory approach that identifies and seeks to correct objectionable conditions requires serious thought and a balanced response by examiners. Critical comments must be well supported and based on facts, logic, and prudent supervisory standards. Although examiners cannot predict future events, they should consider the likelihood that identified weaknesses will cause material problems in the future, and consider the severity of damage to an institution if conditions deteriorate. In circumstances where formal action is considered, examiners should consult with the regional office while the examination is in progress regarding the material needed to support a potential action.

Liquidity CAMELS Rating

The FDIC upgraded First Republic's Liquidity component rating from "2" to "1" with the issuance of the 2021 ROE. As shown in **Table 9** above, the Liquidity rating then remained unchanged until after the first run on deposits in March 2023. However, FDIC examiners identified and were monitoring increased liquidity stress in Q3 and Q4 2022 that merited downgrade of the Liquidity component to a '2'.

In the Q3 2022 LIDI Report, the FDIC assessed Funding Stress as follows:

Funding stress is moderate; the direction of risk is increasing. While the level of High Quality Liquid Assets (HQLA) balances remains high, funding costs have increased. New funding to support loan growth has been supported with higher-cost time deposits and FHLB borrowings. The average rate for all deposits was up 41 basis points, up significantly from the nine basis points observed in 2Q2022. Furthermore, bank management anticipates upward pressure on the rates offered on deposit rates to continue.

UFIRS provides the following **Liquidity Component** rating descriptions:

Component 1: A rating of 1 indicates **strong** liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

Component 2: A rating of 2 indicates **satisfactory** liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices (emphasis added).

The Q3 2022 OGM Report demonstrated that the FDIC maintained the Liquidity component rating of "1", with a 'Negative' 12-month rating outlook. The report states, "CAMELS components remain intact as of 9/30/2022 however the outlook for the liquidity rating has turned negative due to increasing funding costs."

First Republic self-identified its increasing liquidity stress, and discussed the matter in a DERM Committee meeting on November 11, 2022. Meeting minutes provided by First Republic to FDIC examiners stated:

[Bank official] noted that this was the first time the Bank had experienced this nature of a projected shortfall outside of the second quarter where shortfalls were driven by tax outflows and that this was caused in large part by the rapidly changing interest rate environment. [Bank official] explained that the continued expected interest rate raises and upcoming CD maturities could result in a shortfall that would persist over a few quarters noting, however, that this projected shortfall was technical in that the Bank still

had ample FHLB borrowing capacity and an otherwise healthy liquidity position – with the shortfall evidencing a pricing challenge, not a liquid challenge per se...

In the Q4 2022 OGM Report, the FDIC maintained the Liquidity component rating of “1”, with a ‘Negative’ 12-month rating outlook, stating:

CAMELS components remained intact as of 12/31/2022 however the outlook for the liquidity rating has turned negative due to increasing funding costs. During the 2022 Roll Up ROE process that begins in late February, the dedicated team plans to discuss potential liquidity rating change given apparent less favorable operating environment for funding costs.

As previously discussed, UFIRS states that the ‘2’ rating is applicable when “Modest weaknesses may be evident in funds management practices.” The weaknesses in First Republic’s liquidity position in 2022 discussed above aligned with the CAMELS Liquidity component rating of ‘2’.

We interviewed an FDIC official and an FDIC Manager who acknowledged that there was an opportunity for an earlier downgrade to the Liquidity component rating. The Manager stated that as interest rates increased during 2022, the risk profile of First Republic also increased, which presented the opportunity for a downgrade during Q3 and Q4 2022. However, the Manager noted there was not urgency to propose the downgrade because a rating change from a “1” to “2” is relatively less significant than and would not initiate an enforcement action. The FDIC official acknowledged that the FDIC has had a tendency to wait for roll-up ROEs to perform downgrades, and stated that not waiting is a lesson learned from recent bank failures.

The RMS *Continuous Examination Process Procedures* states the following as it relates to interim downgrades:

The ROE will be prepared annually at the end of the FDIC examination cycle. However, interim composite and component rating changes, including specialty exam ratings, should be initiated during the examination cycle when circumstances indicated such change is appropriate.

Ultimately we determined that the FDIC did not downgrade First Republic’s Liquidity rating timely or consistent with its forward looking approach to supervision. An interim downgrade during the Q3 or Q4 2022 may not have prevented First Republic’s failure. However timely supervisory action, including an interim downgrade and associated recommended corrective actions, may have prompted First Republic to take corrective action, possibly reducing its susceptibility to contagion risk or reducing the extent of loss to the DIF upon failure.

We recommend that the Director, Division of Risk Management Supervision:

- **Recommendation 1:** Evaluate why large-bank examination teams may wait to issue CAMELS ratings downgrades until issuance of Reports of Examination (ROEs), rather than promptly when circumstances warrant it as required by the RMS *Continuous Examination Process Procedures*. Then, take corrective action as appropriate.
- **Recommendation 2:** Identify additional communications or adjustments to training curriculum to reemphasize to examiners the importance of timely ratings changes in accordance with the FDIC’s approach to forward-looking supervision.

Management CAMELS Rating and Sensitivity to Market Risk (SMR) MRBA

The FDIC assessed the Management component rating as ‘1’ since at least 2018 until March 31, 2023, after First Republic experienced its first deposit run. The FDIC missed the opportunity to take a more a forward-looking supervisory action when (1) First Republic’s asset/liability mismatch was inconsistent with its own *Interest Rate / Market Risk Management Framework*, (2) First Republic breached its RAS limit for EVE for three consecutive quarters in 2022, and (3) First Republic failed to take appropriate corrective action in response to RAS limit breaches.

FDIC examiners had routinely identified First Republic’s RAS limit breaches. In the 2022 Q2 OGM, the FDIC noted “Sensitivity to negative rate shocks in the short-term remains elevated breaching risk tolerance and risk appetite limits”. Examiners also noted RAS limit breaches in Q3 2022 and Q4 2022 OGM Reports. However, the FDIC did not issue interim ratings downgrades in 2022 nor issue MRBAs or supervisory recommendations pertaining to these matters.

UFIRS provides the following **Management Component** rating descriptions:

Component 1—A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the institution’s size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

Component 2—A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution’s size, complexity, and risk profile. Minor weaknesses may exist, but they are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

We found the FDIC missed the opportunity to downgrade Management from a ‘1’ to a ‘2’ in 2022. Specifically, First Republic did not demonstrate “the ability to promptly and successfully address existing and potential problems and risks” as described for a ‘1’ Management rating. Given that First Republic did not promptly address the aforementioned problems in 2022, the Management CAMELS component rating better aligned with a ‘2’, which states “minor weaknesses may exist, but they are not material to the safety and soundness of the institution and are being addressed.”

Additionally, the FDIC missed the opportunity to issue an MRBA to First Republic for noncompliance with its *Interest Rate / Market Risk Management Framework*, including RAS metric breaches. As previously discussed, MRBAs are intended to help the board prioritize efforts to address examiner concerns, identify emerging problems, and correct deficiencies before a bank’s condition deteriorates.

We recommend that the Director, Division of Risk Management Supervision:

- **Recommendation 3:** Evaluate and update as appropriate examination guidance to require specified supervisory actions when a bank’s business practices do not align with its policies and procedures (e.g., a balance sheet position that does not align with its interest rate policy).
- **Recommendation 4:** Evaluate and update as appropriate examination guidance to require specified supervisory actions when a bank does not take timely and appropriate action when it violates its risk-appetite statement (RAS) metrics (e.g., successive economic value of equity [EVE] breaches without corrective action by First Republic).

Evaluating the Impact of First Republics' Concentration in Uninsured Deposits

First Republic's concentration in uninsured deposits was frequently identified by FDIC examiners across examination cycles. FDIC examiners also documented several factors that bank regulators have historically believed help mitigate the potential volatility of uninsured deposits, including:

- The length of customers' relationships with First Republic.
- Low historical customer attrition rates.
- High number of products and services per customer household.
- Concentration in uninsured deposits was across a large number of customers. There was not a concentration in a small number of customers.
- Effective controls implemented by First Republic to monitor the stability of its deposits.

The FDIC's assessment of First Republic's uninsured deposits was consistent with the Manual. We found, however, that the uninsured deposit outflows from First Republic, as well as recent deposit runs at other prominent regional banks, necessitates that the FDIC re-evaluate its assumptions about the potential effectiveness of factors considered as mitigations to reduce the volatility of uninsured deposits in a stress event. We also determined that the FDIC should re-evaluate its expectations for banks' stress testing assumptions pertaining to uninsured deposit outflows.

As previously discussed, perceived similarities between SVB and First Republic, as well as adverse media and capital markets activity contributed towards the loss in confidence in First Republic and the resulting runs on deposits. In light of these factors, the FDIC should re-evaluate its process for identifying and monitoring systemic risks across banks with actual or perceived similarities, and assess whether additional monitoring of publicly-available media and capital markets activity may improve its supervisory process.

The following subsections discuss the FDIC's assessment of First Republic's uninsured deposits, stress testing, and potential contagion risk to First Republic following the run on deposits at SVB. Cotton also provides recommendations in each of these areas.

Assessment of First Republic's Uninsured Deposits

The FDIC appropriately identified and assessed First Republic's concentration in uninsured deposits and mitigating factors based on the RMS Manual. We found, however, the recent events surrounding First Republic's failure call for reconsideration and possible amendment to, or expansion of, this guidance. The *RMS Manual of Examination Policies* outlines the following regarding uninsured deposits:

While some deposit relationships over \$250,000 remain stable when the institution is in good condition, such relationships might become less stable due to their uninsured status, if the institution experiences financial problems. Additionally, deposits identified as stable during good economic conditions may not be reliable funding sources during stress events. Therefore, examiners should consider whether institutions identify deposit accounts likely to be unstable in times of stress and appropriately reflect such deposits in its liquidity stress testing.

Although RMS's guidance calls for examiners to consider the stability of uninsured deposits, the guidance also states that large deposits might be more stable if the deposit is difficult to move, or if the depositor has a longer history with the institution. Specifically, the Manual explains:

A large deposit account might be considered stable if the customer has ownership in the institution, has maintained a long-term relationship with the bank, has numerous accounts, or uses multiple bank services. Conversely, a large depositor that receives a high deposit rate, but maintains no other relationships with the institution, may move the account quickly if the rate is no longer considered high for the market. Therefore, examiners should consider the overall relationship between customers and the institution when assessing the stability of large deposits.

Insured deposits and borrowing secured by highly liquid assets are more likely to be stable than uninsured deposits or borrowings secured by non-liquid assets. Uninsured deposits should not automatically be considered volatile; however, the historical and projected stability of uninsured deposits should be assessed.

Following are selected examples of FDIC examiners identifying the risk pertaining to First Republic's concentration in uninsured deposits, and related mitigating factors:

Q2 2022 LIDI Report: Systems for monitoring deposit stability have been strengthened with custom monitoring tools and increased management oversight. Internal ongoing monitoring of large and uninsured accounts indicates overall stable characteristics including an average tenure of eight years and an average of 20 service offerings per relationship.

2021 Deposit and Interest Rate Risk Target Review: Mitigating factors center on well-developed large depositor client relationships, which exhibit characteristics that indicate the likelihood of continued stability. The top one percent of client relationships...are comprised of 2,800 unique client relationships with an average account tenure of over 7.5 years and 21 services per relationship.

The uninsured deposit outflows from First Republic demonstrated that the mitigating factors, widely accepted by the FDIC and other federal regulators, were not sufficiently effective.

Recommendation 5: We recommend that the Director, Division of Risk Management Supervision comprehensively re-evaluate the Manual to determine whether updates to examination guidance are needed pertaining to evaluation of the stability of uninsured deposits, including the potential effectiveness of mitigating factors.

Assessment of First Republic's Stress Testing Models

FDIC examiners concluded that First Republic's stress testing was sufficiently robust in 2022. The FDIC's conclusion was substantiated by First Republic's ability to withstand deposit outflows exceeding \$100 billion. However, the unprecedented magnitude and velocity of uninsured deposit outflows experienced by First Republic, and other prominent regional banks, necessitates that the FDIC re-evaluate its liquidity stress testing expectations, including those

regarding the potential for uninsured deposit outflows in a stress event. Related to liquidity stress testing, the Manual states:

Liquidity stress tests are typically based on existing cash-flow projections that are appropriately modified to reflect potential stress events (institution-specific or market-wide) across multiple time horizons. Stress tests are used to identify and quantify potential risks and to analyze possible effects on the institution's cash flows, liquidity position, profitability, and solvency. For instance, during a crisis an institution's liquidity needs can quickly escalate while liquidity sources can decline (e.g., customers may withdraw uninsured deposits, or lines of credit may be reduced or canceled). Stress testing allows an institution to evaluate the possible impact of these events and plan accordingly.

On October 14, 2022, FDIC examiners issued a Supervisory Letter following completion of the 2022 Market and Funding Risk target review. FDIC examiners found that First Republic's liquidity stress testing framework and associated models remained appropriate for its risk profile and that all liquidity stress testing-related expert judgment models had satisfactory design, validation, and ongoing monitoring. In addition, examiners found the capital stress testing program to be appropriate and that First Republic had sufficient capital under stressed conditions. The letter stated:

The Stress Test Scenario is sufficiently robust to capture severe, prolonged detrimental effects to capital throughout First Republic. The key stress test assumptions are sufficiently harsh to fulfill the intent of the stress test exercise.

Recommendation 6: In light of the unexpected uninsured deposit outflows experienced by First Republic, we recommend that the Director, Division of Risk Management Supervision comprehensively re-evaluate the Manual to determine whether updates to examination guidance are needed pertaining to the evaluation of banks' deposit outflow assumptions for liquidity stress testing, including the magnitude and velocity of uninsured deposit outflows.

Assessment of Potential Contagion Effect from SVB

On March 8, 2023, SVB released news that it was selling the majority of its AFS securities portfolio at a loss and raising capital as part of plans to reposition its balance sheet. SVB also lowered guidance as a result of higher-than-expected cash burn amongst its heavy concentration of private equity and venture capital clients. In response, FDIC examiners promptly assessed potential contagion impact to First Republic in a memorandum dated March 9, 2023, including First Republic's exposure to private equity and venture capital.

Although First Republic and SVB had different business models and different risk exposures, the run on deposits at First Republic following the SVB failure demonstrated that depositors perceived similarities between First Republic and SVB. As discussed previously, FDIC examiners stated that the SVB and First Republic depositors were connected with each other, due to the generally high-net-worth customers and geographic location, and behaved in a coordinated or similar way by rapidly withdrawing uninsured deposits.

Depositors' perceived relationships or likeness between banks was also an important factor in other recent bank failures. For example, Silvergate Bank and SBNY both had concentrations in deposits from crypto-asset firms.

We recommend that the Director, Division of Risk Management Supervision:

- Comprehensively re-evaluate examination guidance to determine whether updates are needed in the areas of:
 - **Recommendation 7:** Proactive horizontal identification and monitoring of similarities across banks – including like business characteristics and risks, and like reputational characteristics – that may result in similar behaviors amongst their depositors, including shared risk characteristics that may result in increased contagion risk between institutions.
 - **Recommendation 8:** Incorporating shared risk characteristics that may result in increased contagion risk between institutions into the FDIC’s supervisory approach across large institutions.

Two examiners separately informed Cotton that additional information from public sources pertaining to regulated financial institutions would help improve the supervisory process. As previously discussed, adverse media and capital markets activity contributed towards the loss in confidence in First Republic and the resulting run on deposits. One examiner expressed that periodic briefings on publicly available social media activity would be helpful. Another examiner expressed that monitoring and analysis of capital markets activity would be helpful.

In light of First Republic’s failure, we recommend that the Director, Division of Risk Management Supervision implement the following matter for further study of the FDIC Chief Risk Officer in its report *FDIC’s Supervision of First Republic Bank*:

- **Recommendation 9:** Explore potential processes and information sources for real-time monitoring of large bank reputational risk. Potential information sources could include bank share price tracking websites, short seller activity, and social media discussions.

COMPLIANCE WITH PROMPT CORRECTIVE ACTION (PCA)

FDI Act Section 38, *Prompt Corrective Action*, establishes a framework of mandatory and discretionary supervisory actions for insured depository institutions that are not adequately capitalized. Regulators are required to take certain supervisory actions known as “prompt corrective actions,” if an institution’s capital level deteriorates. The purpose of Section 38 is to resolve problems of insured depository institutions at the least possible cost to the DIF.

The FDIC found that First Republic was well-capitalized throughout each examination cycle based on defined capital measures. Accordingly, the FDIC had not taken any action with respect to PCA requirements. Cotton found that FDIC examiners assessed Capital appropriately based on the PCA framework. We did not identify any exceptions in this area. In hindsight, however, First Republic’s Capital proved insufficient to absorb losses and promote public confidence due to unrealized fair value losses, as well as concentration in uninsured deposits, resulting in a final estimated loss to the DIF of \$15.6 billion.

We summarize below the purpose of Capital and how it is assessed by regulators, the FDIC’s appropriate conclusion that First Republic was well-capitalized under the PCA Framework, and the impact (or lack of impact) of fair values on assessment of Capital under the PCA Framework. We then provide our related recommendations.

Purpose of Capital and the FDIC's Assessment of Capital

Functions of Bank Capital: The Manual explains the four essential functions of Capital, as shown in **Table 10**:

Table 10: Essential Functions of Bank Capital:

Absorbs Losses	Capital allows institutions to continue operating as going concerns during periods when operating losses or other adverse financial results are experienced.
Promotes Public Confidence	Capital provides a measure of assurance to the public that an institution will continue to provide financial services even when losses have been incurred, thereby helping to confidence in the banking system and minimize liquidity concerns.
Restricts Excessive Asset Growth	Capital, along with minimum capital ratio standards, can act as a constraint on expansion by requiring that asset growth be funded by a commensurate amount of capital.
Protects Depositors and the DIF:	Placing owners at significant risk of loss, should the institution fail, helps to minimize the potential for moral hazard, and promotes safe and sound banking practices.

Source: The FDIC's *RMS Manual of Examination Policies* (the Manual).

FDIC examiners concluded that First Republic was well-capitalized throughout each examination cycle based on defined capital measures. However, First Republic's capital position failed to fulfill the essential functions of Bank Capital—to promote public confidence, fully absorb losses, and protect depositors and the DIF.

Categories of Capital Standards: In 2019, federal regulators adopted rules establishing four categories of capital standards for U.S. banking organizations with \$100 billion or more in total assets and foreign banking organizations with \$100 billion or more in combined U.S. assets. See **Table 11** below. First Republic was a Category IV institution.

Table 11: Categories of Capital Standards

Category I	Applies to U.S. global systemically important bank holding companies and their depository institution subsidiaries.
Category II	Applies to banking organizations with at least \$700 billion in total consolidated assets or at least \$75 billion in cross-jurisdictional activity and their depository institution subsidiaries.
Category III	Applies to banking organizations with total consolidated assets of at least \$250 billion or at least \$75 billion in weighted short-term wholesale funding, nonbank assets, or off-balance sheet exposure and their depository institution subsidiaries.
Category IV	Applies to banking organizations with total consolidated assets of at least \$100 billion that do not meet the thresholds for a higher category and their depository institution subsidiaries. ²⁵

Source: Federal Register Notice, *Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity*.

Summary of Tier 1 and Tier 2 Capital: The FDIC evaluates Capital Adequacy in accordance with 12 CFR § 324 FDIC, *Capital Adequacy of FDIC-Supervised Institutions*. Part 324 establishes two broad components of capital which are known as Tier 1 Capital and Tier 2 Capital. Components of Tier 1 and Tier 2 Capital are used to calculate minimum regulatory capital ratios defined in Part 324, as shown above. **Table 12** summarizes Tier 1 and 2 capital from the RMS manual.

²⁵ See 12 CFR § 3.2 (OCC), 12 CFR § 252.5, 12 CFR § 238.10 (Board), 12 CFR § 324.2 (FDIC); "Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations," 84 FR 59032 (November 1, 2019); and "Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements," 84 FR 59230 (November 1, 2019).

Table 12: Summary of Tier 1 and 2 Capital

Tier 1 Capital	Common equity tier 1 capital is the most loss-absorbing form of capital. It includes qualifying common stock and related surplus net of treasury stock; retained earnings; certain accumulated other comprehensive income (AOCI) elements if institution management does not make an AOCI opt-out election, plus or minus regulatory deductions or adjustments as appropriate; and qualifying common equity tier 1 minority interests. The Federal banking agencies expect the majority of common equity tier 1 capital to be in the form of common voting shares and retained earnings.
Tier 2 Capital	Tier 2 capital includes the allowance for loan and lease losses (ALLL) up to 1.25 percent of risk-weighted assets, qualifying preferred stock, subordinated debt, and qualifying tier 2 minority interests, less any deductions in the tier 2 instruments of an unconsolidated financial institution.

Source: The FDIC's *RMS Manual of Examination Policies* (the Manual).

First Republic was Well-Capitalized under the PCA Framework

Under the PCA framework, there are four capital ratios which outline minimum regulatory capital requirements for insured depository institutions. **Table 13** summarizes the thresholds for each capital ratio in order for an institution to be considered well-capitalized, adequately capitalized, undercapitalized, and significantly undercapitalized. Banks must meet all four ratios within a category to qualify for that category.

Table 13: PCA Capital Requirements

Capital Ratio	Well-Capitalized	Adequately Capitalized	Undercapitalized	Significantly Undercapitalized
Tier 1 leverage ratio	5% or greater	4% or greater	Less than 4%	Less than 3%
Common Equity Tier 1 (CET1) ratio	6.5% or greater	4.5% or greater	Less than 4.5%	Less than 3%
Tier 1 risk-based capital ratio	8% or greater	6% or greater	Less than 6%	Less than 4%
Total risk-based capital ratio	10% or greater	8% or greater	Less than 8%	Less than 6%

Source: The FDIC's *Formal and Informal Enforcement Actions Manual*.

The FDIC appropriately assessed that First Republic was well-capitalized based on the PCA framework, as shown in **Table 14** below:

Table 14: Summary of First Republic's Capital Ratios

Capital Ratio	12/31/2022	12/31/2021	12/31/2020
Tier 1 leverage ratio	8.51%	8.76%	8.14%
CET1 ratio	9.17%	9.65%	9.67%
Tier 1 risk-based capital ratio	11.56%	12.56%	11.18%
Total risk-based capital ratio	12.60%	13.72%	12.55%
Classification	Well-Capitalized	Well-Capitalized	Well-Capitalized

Source: Calculated based on 2020 – 2022 Uniform Bank Performance Reports (UBPRs).

In light of the impact fair value declines had on the failure of First Republic, as well as SVB, the FDIC's supervision practices warrant additional consideration. As previously discussed, First Republic experienced significant declines in the fair value of its assets due to increasing interest rates beginning in 2022. As of December 31, 2022, the decline in the fair value of First Republic's assets exceeded its total equity. The decline in the fair value of its assets, in addition to concentration in uninsured deposits, contributed to the loss of confidence in First Republic. Although First Republic was able to withstand the first run on deposits beginning March 10,

2023, declines in the fair value of First Republic's assets also contributed to its inability to recover following the deposit run.

First Republic's Form 10-K filing with the U.S. Securities and Exchange Commission includes a Summary of Significant Accounting Policies based on U.S. Generally Accepted Accounting Principles (GAAP). The subsections below summarize First Republic's accounting policies, and their impact on the FDIC's assessment of Capital based on the PCA framework. Discussion is presented in order of least to most important to First Republic as follows: (1) AFS securities, (2) held-to-maturity (HTM) securities, and (3) loans. Unrealized fair value losses on loans were by far the most significant to First Republic; however, Cotton included assessment of AFS and HTM securities to present a broader view as the relative significance of these assets may vary across banks.

AFS Securities: As of December 31, 2022, First Republic reported \$471 million in unrealized losses in AFS securities. The Bank's GAAP-based accounting policy from the Form 10-K filing pertaining to available-for-sale securities follows:

Debt securities that First Republic may not hold until maturity are classified as securities available-for-sale and reported at fair value. Unrealized losses resulting from credit losses on available-for-sale debt securities are recognized in earnings as a provision for credit losses. Unrealized losses that do not result from credit losses are excluded from earnings and reported as accumulated other comprehensive income, net of applicable taxes, which is included in equity.

Part 324 allowed all non-advanced approach institutions²⁶, including First Republic, to make a permanent, one-time opt-out election, enabling them to calculate regulatory capital without accumulated other comprehensive income (AOCI). Such an election neutralizes the impact of unrealized gains or losses pertinent to balance sheet assets, including available-for-sale bond portfolios, in the context of regulatory capital levels. The Part 324 allowance for Banks to opt-out of the inclusion of AOCI in regulatory capital is applicable only to Category III and IV banks, such as First Republic.

Although unrealized losses on AFS securities were reported by First Republic as AOCI, a component of Shareholders' Equity, in its financial reports, First Republic exercised the opt-out election allowed by Part 324. Accordingly, AOCI was excluded from the capital ratios evaluated by FDIC examiners, as described above.

The FDIC recently proposed a rule to eliminate the AOCI exclusion. On July 27, 2023—following recent bank failures—federal bank regulatory agencies²⁷ requested comment on a proposed rule to increase the strength and resilience of the banking system by modifying large bank capital requirements to better reflect underlying risks and increase the consistency of how banks measure risks. The proposed rule includes the following:

²⁶ According to the Federal Reserve Board, "The Advanced Approaches capital framework requires certain banking organizations to use an internal ratings-based approach and other methodologies to calculate risk-based capital requirements for credit risk and advanced measurement approaches to calculate risk-based capital requirements for operational risk. The framework applies to large, internationally active banking organizations—generally those with at least \$250 billion in total consolidated assets or at least \$10 billion in total on-balance sheet foreign exposure—and includes the depository institution subsidiaries of those firms".

²⁷ These consist of OCC; the Board of Governors of the Federal Reserve System; and the FDIC.

Under the proposal, consistent with the treatment applicable to banking organizations subject to Category I or II capital standards, banking organizations subject to Category III or IV capital standards would be required to include all AOCI components in common equity tier 1 capital, except gains and losses on cash-flow hedges where the hedged item is not recognized on a banking organization's balance sheet at fair value. This would require all net unrealized holding gains and losses on available-for-sale (AFS) debt securities from changes in fair value to flow through to common equity tier 1 capital, including those that result primarily from fluctuations in benchmark interest rates. This treatment would better reflect the point in time loss-absorbing capacity of banking organizations subject to Category III or IV capital standards and would align with banking organizations subject to Category I or II capital standards.

HTM Securities: As of December 31, 2022, First Republic disclosed in its financial statement footnotes within its 10-K filing \$4.839 billion in unrealized losses in HTM securities. The Bank's GAAP-based accounting policy pertaining to HTM securities follows:

Debt securities that First Republic has the intent and ability to hold to maturity are classified as held-to-maturity and reported at amortized cost, excluding interest receivable. Interest receivable is separated from other components of amortized cost and presented within "Other assets" on the consolidated balance sheets.

Unrealized losses on HTM securities were disclosed, but did not affect First Republic's balance sheet (including AOCI) in accordance with GAAP. Therefore, they did not affect First Republic's capital ratios evaluated by examiners.

Loans: As of December 31, 2022, First Republic disclosed in its financial statement footnotes a difference of \$22.159 billion between the amortized cost less allowance and estimated fair value of its loans. The Bank's GAAP-based accounting policy pertaining to loans follows:

Loans are reported at amortized cost, which consists of their outstanding principal balances net of any charge-offs, unamortized deferred fees and costs on originated loans and any premiums or discounts on purchased loans, excluding interest receivable. Interest receivable is separated from other components of amortized cost and presented within "Other assets" on the consolidated balance sheets.

Because the estimated fair value of loans were disclosed, but did not affect First Republic's balance sheet (including AOCI), they did not affect First Republic's capital ratios evaluated by examiners.

FDIC's Identification of the Impact of Declines in Fair Value on First Republic: The FDIC acknowledged the impact that declines in fair value had on First Republic following the deposit runs and its eventual failure. Specifically, the FDIC's interim CAMELS ratings downgrade letter to First Republic dated April 28, 2023, stated:

Efforts to raise additional capital, sell assets, and/or sell the institution have not materialized, and near-term prospects to do so are unlikely. As of the date of this letter, the bank has not yet been successful at selling any assets due to the market value of loans and securities being well below book values and the resultant losses contained within those assets that would deplete existing capital resources in a market sale.

In prepared testimony to the U.S. House of Representatives, Committee on Financial Services on May 16, 2023, the FDIC Chairman stated that:

First Republic Bank highlighted a related risk characteristic to unrealized losses on securities, namely the difference between the fair value and amortized cost of loans. The amortized cost and fair value of securities, which provide the data to determine related unrealized losses, are readily available and reported quarterly on all insured institutions' Consolidated Reports of Condition and Income (Call Report).

In accordance with U.S. Generally Accepted Accounting Principles (GAAP), publicly traded banks and bank holding companies include fair value measurement disclosures on appropriate classes of assets and liabilities, which may include loans, in the notes to consolidated financial statements, but they are not required to report loans intended to be held for investment at fair value on their financial statements or Call Report. Unlike SVB, First Republic Bank's unrealized losses on its securities portfolio did not exceed its capital, per its Call Report, it was not experiencing deposit withdrawals, and it did not sell assets at a loss to meet withdrawals. Nonetheless, the bank's long-dated and low yielding loan portfolio resulted in a large difference between the amortized cost and fair value of the bank's loans.

At least beginning on March 10, 2023, reports began to highlight, and social media and short seller forums began to amplify, banks and bank holding companies with high levels of uninsured deposits that also had notable differences between the fair value of loans reported in public financial statements and the loans' amortized cost, including First Republic.

Recommendations

As the regulators update and finalize the proposed rule modifying large bank Capital requirements, we recommend that the Director, Division of Risk Management Supervision:

- **Recommendation 10:** Implement the matter for further study from the Chief Risk Officer to evaluate whether Continuous Examination Process (CEP) examination teams should place greater consideration and emphasis on unrealized losses and declines in fair value (in both securities and loans).

As previously discussed within this report, the FDIC uses the safety and soundness standards specified in Section 39 of the FDI Act to identify and address problems at institutions before Capital becomes impaired. First Republic's failure to sufficiently manage its interest rate risk resulted in significant unrealized fair value losses. These unrealized fair value losses limited the bank's ability to sell assets, but did not affect First Republic's Capital under the PCA framework. However, events surrounding the failure of First Republic Bank, and other recent bank failures, may warrant changes to the guidelines establishing standards for safety and soundness, including the adoption of noncapital triggers that would require regulatory actions. As a result, we recommend that the Director, Division of Risk Management Supervision:

- **Recommendation 11:** Engage with other federal regulators to evaluate the need for changes to rules under the safety and soundness standards, including the adoption of noncapital triggers that would require early and forceful regulatory actions tied to unsafe banking practices before they impair capital.

APPENDIX I: OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

Pursuant to the relevant requirements of the Federal Deposit Insurance (FDI) Act, 12 U.S.C. § 1831o(k), and our contractual requirements with the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General (OIG), the objectives of our engagement were to (1) determine why First Republic Bank's (First Republic) problems resulted in a material loss to the Deposit Insurance Fund (DIF) and (2) evaluate the FDIC's supervision of First Republic, including the FDIC's implementation of the Prompt Corrective Action (PCA) requirements of section 38 of the FDI Act, and make recommendations for preventing any such loss in the future.

We conducted this Material Loss Review (MLR) in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* (commonly referred to as the Blue Book). In addition, we conducted this engagement in accordance with the American Institute of Certified Public Accountants' *Statement on Standards for Consulting Services*.

We performed our work from May 2023 through November 2023 at the Cotton office in Alexandria, Virginia and remotely. In conducting our work and preparing the report, we relied primarily on supervisory records, bank documents, and other information provided by the FDIC's Division of Risk Management Supervision (RMS). This review fulfills a statutory mandate and does not serve any investigatory purposes.

Scope and Methodology

The scope of our MLR covered examinations performed and supervisory actions taken by the FDIC from 2018 until First Republic failed on May 1, 2023, with emphasis on the periods 2020–2023. To accomplish our objectives, we evaluated:

- Relevant aspects of the FDI Act.
- Pertinent FDIC policies, procedures, and guidance, including the RMS *Manual of Examination Policies* (the Manual), Continuous Examination Process (CEP) Procedures, *Formal and Informal Enforcement Actions Manual*, and Large Insured Depository Institution (LIDI) Instructions.
- Selected First Republic Form 10-K filings with the Securities and Exchange Commission, Uniform Bank Performance Reports (UBPRs), Consolidated Reports of Condition and Income for A Bank With Domestic and Foreign Offices (Call Reports), business plans, policies and procedures, board and committee meeting minutes, and other internal bank reports and communications retained by FDIC examiners.
- Information pertinent to the economic environment, such as interest and inflation rates.
- Selected correspondence and examination documentation located in the Regional Automated Document Distribution and Imaging System (RADD) database, including Supervisory Plans, Supervisory Letters, Reports of Examination (ROE), Ongoing Monitoring (OGM) reports, LIDI Reports, and Confidential Problem Bank Memoranda.

- The FDIC's Failed Bank Case.
- The FDIC's report, *FDIC's Supervision of First Republic Bank*, dated September 8, 2023.
- Testimony presented to the U.S. House of Representatives Committee on Financial Services and to the U.S. Senate Committee on Banking, Housing, and Urban Affairs.

We interviewed officials from the FDIC's RMS, including from the Large Bank Supervision (LBS) section; San Francisco Regional Office (SFRO); and personnel from the former dedicated First Republic examination team. We also interviewed officials and examiners from DFPI. We obtained their perspectives on the principal causes of First Republic's failure, the supervisory approach, and other examination-related information.

We performed certain procedures to determine whether the FDIC had complied with relevant Prompt Corrective Action provisions in Section 38 of the FDI Act.

We obtained data from two FDIC systems, the Virtual Supervisory Information on the Net (ViSION) and RADD. We determined that information system controls pertaining to these systems were not significant to the evaluation objectives. Therefore, we did not evaluate the effectiveness of the FDIC's information system controls as part of this engagement.

We incorporated technical comments from RMS on a draft copy of this report.

APPENDIX II: MATTERS FOR FURTHER STUDY

Matters for further study provided by the Federal Deposit Insurance Corporation (FDIC) Chief Risk Officer (CRO) are compiled in the table below.

Sources	Matters for Further Study
FDIC CRO Report	Reiterate expectations and examiner resources for evaluating interest rate risk management during CEP [Continuous Examination Procedures].
FDIC CRO Report	Consider the need for enhanced examination guidance related to supervising banks that are overly reliant on uninsured deposit funding or have concentrations in uninsured deposits.
FDIC CRO Report	Evaluate whether CEP examination teams should place greater consideration and emphasis on unrealized losses and declines in fair value (in securities and loans) and whether additional information fields should be required in Call Reports.
FDIC CRO Report	Continue to evaluate the CEP and implement necessary changes to ensure the CEP provides efficient, effective, and timely risk-based feedback to large banks, including interim CAMELS ratings, when appropriate.
FDIC CRO Report	Evaluate existing CEP required deliverables and level-of-effort to prepare deliverables in relation to benefits derived. Look for opportunities to streamline program requirements and written deliverables.
FDIC CRO Report	Explore opportunities for LBS [Large Bank Supervision] to provide horizontal and trend LIDI [Large Insured Depository Institution] information to examination teams for benchmarking and to provide a broader large bank perspective.
FDIC CRO Report	Explore potential processes and information sources for real-time monitoring of large bank reputational risk profiles. Potential information sources could include bank share price tracking websites, short seller activity, and social media discussions.
FDIC CRO Report	Confer with other CEP teams to see if they also experience delays in receiving information about bank board of director decisions and explore alternatives for obtaining decision information sooner.

APPENDIX III: RECENT TARGET REVIEWS & SUPERVISORY ACTIONS

Target Review / Supervisory Letter	Date Issued	Review Description / Supervisory Recommendations (SRs) and Matters Requiring Board Attention (MRBAs) (if any)
2018 Examination Cycle		
SL #01-2018 <i>Corporate Governance</i>	2018.04.26	Review focused on systems and processes for managing strategic risk and assuring data quality. The assessments of strategic risk covered the strategic planning process, as well as methods used by the Enterprise Risk Management group to measure and monitor risk.
SL #02-2018 2018 Dodd-Frank Act Stress Test (DFAST)	2018.06.20	<p>Review assessed the 2018 DFAST Capital Plan submission and supporting documentation, focused on the credibility of stressed capital ratio outcomes.</p> <p>SR # 02-2018-01: <i>Effective Challenge for Qualitative Models</i> <i>Description:</i> Amend MRM policies and procedure to remove materiality thresholds and capital stress testing criteria as determinants of a qualitative model.</p> <p>SR # 02-2018-02: <i>Qualitative Model Inventory and Definition</i> <i>Description:</i> Ensure independent model validation reports for models relying substantially on qualitative inputs for demonstrating effective challenge.</p> <p><i>Closed:</i> All SRs opened during the 2018 examination cycle had been remediated as of the issuance of the 2019 ROE.</p>
SL #03-2018 <i>Operations Risk</i>	2018.07.18	<p>Review covered operational processes and controls of the Accounting and Human Resources functional groups.</p> <p>SR # 03-2018-1: <i>Business Process Control for Gradifi</i> <i>Description:</i> Management should ensure that account control and account reconciliation are delegated to different individuals for all transaction accounts used in the Gradifi operation.</p> <p>SR # 03-2018-2: <i>Information Security Program for Gradifi</i> <i>Description:</i> Management should strengthen the information security program for Gradifi by improving/clarifying the Written Information Security Policy, Information Security Governance Plan, and Incident Response Plan.</p> <p><i>Closed:</i> All SRs opened during the 2018 examination cycle had been remediated as of the issuance of the 2019 ROE.</p>
SL #04-2018 <i>IT Part I</i>	2018.09.24	Review evaluated the Audit and Management rating components of the Uniform Rating System for Information Technology. Examiners assessed First Republic's IT audit capabilities, IT governance practices, cybersecurity program oversight, vendor management oversight, business continuity resiliency, and compliance with IT-related laws and regulations.
SL #05-2018 <i>Commercial Loans</i>	2018.09.06	Review assessed the credit quality of the commercial loan portfolios with emphasis on multifamily lending in New York City.
SL #06-2018 <i>Market & Funding Risk</i>	2018.10.18	<p>Review covered the risk and risk management processes associated with the areas of liquidity, deposits, sensitivity to market risk, and investments.</p> <p>SR # 06-2018-1: <i>LST Brokered and High-Rate Deposits</i> <i>Description:</i> Ensure the Liquidity Stress Testing (LST) scenario assuming a below well-capitalized condition considers the regulatory restrictions on renewing high-rate or brokered deposits.</p> <p>SR # 06-2018-2: <i>LST Assumptions Review and Approval</i> <i>Description:</i> Establish a formal process to periodically review and approve model assumptions used in the LST.</p> <p>SR # 06-2018-3: <i>LST Ongoing Monitoring</i> <i>Description:</i> Develop a formal ongoing monitoring plan for LST-1 that confirms the model is appropriately implemented and performing as intended.</p>

Target Review / Supervisory Letter	Date Issued	Review Description / Supervisory Recommendations (SRs) and Matters Requiring Board Attention (MRBAs) (if any)
		<p>SR # 06-2018-4: <i>LST Model Documentation</i> Description: First-line management should document the LST-2 model in accordance with First Republic's established model documentation standards and all known weaknesses are addressed prior to model revalidation and implementation.</p> <p>SR # 06-2018-5: <i>Intra-Period Liquidity Reporting</i> Description: Reassess the practice of using month-end balances to calculate Key Risk Indicators used for liquidity monitoring.</p> <p>Closed: All SRs opened during the 2018 examination cycle had been remediated as of the issuance of the 2019 ROE.</p>
SL #07-2018 <i>Retail Lending</i>	2018.12.03	Review assessed the credit quality of the retail loan portfolios, including all lending territories and serviced loans.
SL #08-2018 <i>IT Part II</i>	2019.01.30	Review evaluated the Development and Acquisition and Support and Delivery rating components of the Uniform Rating System for Information Technology. Examiners assessed project management, change management procedures, new vendor due diligence, info security program, cybersecurity readiness, and retail and wholesale payment systems.
SL #09-2018 <i>Trust Services</i>	2019.01.10	Review assessed the components of the Uniform Interagency Trust Rating System including: Management; Operations, Internal Controls, and Audit; Compliance; Asset Management; and Earnings.
SL #10-2018 <i>BSA / AML</i>	2019.01.10	Review covered First Republic Secrecy Act/ Anti-Money Laundering (BSA/AML), fraud, and Office of Foreign Assets Control programs. The review encompassed an understanding of First Republic's risks associated with these areas, and reviewed management oversight, internal controls, audit coverage, and training designed to identify, manage, monitor, and control such risks.
2018 ROE	2019.05.15	2018 Report of Examination
2019 Examination Cycle		
SL #01-2019 <i>Private Wealth Management</i>	2019.03.11	Review encompassed a broad overview of the Private Wealth Management (PWM) business as of 9/30/18, to determine any material changes in the PWM business model, strategy, or operations since the prior review.
SL #02-2019 <i>Commercial Non-Real Estate Lending</i>	2019.04.04	Review assessed the credit quality of the commercial loan portfolios along with relevant components of the credit risk management program including: credit underwriting, credit administration, independent loan review, credit grading, management reporting, stress testing, and compliance with applicable regulations.
SL #03-2019 <i>Corporate Governance</i>	2019.05.31	Review encompassed a broad overview of Corporate Governance from a risk management perspective as of 12/31/18. The review focused on the Corporate Governance framework and the Enterprise Risk Management program, including Model Risk Management (MRM).
SL #04-2019 <i>Stress Testing</i>	2019.06.05	Review assessed stress testing as of 3/31/19, including the overall stress testing program, the impact of the stress testing results, validation of stress testing models, and an in-depth review of the model for forecasting interest rate risk.
SL #05-2019 <i>Commercial Real Estate Lending</i>	2019.07.02	Review assessed the credit quality of the commercial real estate loan portfolios along with relevant components of the credit risk management program: credit underwriting, credit administration, independent loan review, credit grading, management reporting, stress testing, and compliance with applicable regulations.
SL #06-2019 <i>IT Part I</i>	2019.08.27	Review evaluated the Audit and Management rating components of the Uniform Rating System for Information Technology. Examiners assessed First Republic's IT audit capabilities, IT governance practices, cybersecurity program oversight, vendor management oversight, business continuity resiliency, and compliance with IT-related laws and regulations.
SL #07-2019 <i>Operations Risk</i>	2019.08.12	Review assessed systems and processes for controlling operational risk as of 3/31/19. The scope incorporated broad aspects of risk management including the overall operational risk management program and compliance with the Sarbanes-Oxley Act of 2002.
SL #08-2019 <i>Deposit Stability</i>	2019.10.09	Review assessed the stability of deposits and the systems and processes for monitoring and controlling risk associated with deposit volatility as of 6/30/19.

Target Review / Supervisory Letter	Date Issued	Review Description / Supervisory Recommendations (SRs) and Matters Requiring Board Attention (MRBAs) (if any)
		<p>SR # 08-2019-1: <i>LST Scaling Assumptions</i> <i>Description:</i> Management should validate the scaling factors used for the Deposit outflow Calibration model in the Liquidity Stress Test framework by taking the following actions: -Test, evaluate, and document the correlation between the outflows of different segments over the various time horizons to determine the extent of actual correlation; -Assess whether and to what extent correlations in deposit movements affect aggregate deposit flows under stressed conditions; and, -Determine if the scaling factors used in the LST framework to lower the stressed outflow rates remain appropriate or require adjustment based on the correlation testing results.</p> <p><i>Closed:</i> All open SRs had been remediated as of the issuance of the 2019 ROE.</p>
SL #09-2019 <i>Trust Services</i>	2019.11.26	Review assessed all components of the Uniform Interagency Trust Rating System capability of management; adequacy of operations, controls and audits; quality and level of earnings; compliance with governing instruments, applicable law, and sound fiduciary principles; and, management of fiduciary assets.
SL #10-2019 <i>IT Part II</i>	2019.12.17	Review evaluated the Development and Acquisition and Support and Delivery rating components of the Uniform Rating System for Information Technology. Examiners assessed project management, change management procedures, new vendor due diligence, info security program, cybersecurity readiness, and retail and wholesale payment systems.
SL #11-2019 <i>Retail Lending</i>	2019.12.17	Review assessed the credit quality of the retail loan portfolios, including all lending territories and serviced loans.
SL #11-2019 <i>BSA / AML</i>	2019.12.19	Review covered the BSA/AML, fraud, and Office of Foreign Assets Control programs. The review encompassed an understanding of First Republic's risks associated with these areas, and reviewed management oversight, internal controls, audit coverage, and training designed to identify, manage, monitor, and control such risks.
2019 ROE	2020.05.07	2019 Report of Examination
2020 Examination Cycle		
SL #01-2020 <i>Commercial Lending</i>	2020.04.21	Review assessed the credit quality of commercial loan portfolios, which encompassed all non-real estate oriented commercial lending portfolios: Capital Call Lines of Credit, Commercial and Industrial, Not-for-Profit, Eagle Professional Lending Program, and Commercial Unsecured.
SL #02-2020 <i>Corporate Governance</i>	2020.06.08	Review assessed individual components of the corporate governance program associated with structured compensation, credit claw-backs, customer complaints, and pending litigation, as well as the role of these individual components in the overall corporate governance framework.
SL #03-2020 <i>Stress Testing</i>	2020.06.09	Review focused on the Capital Stress Test and the Current Expected Credit Loss reserve methodology, including the credit loss models underpinning both programs.
SL #04-2020 <i>Commercial Real Estate Lending</i>	2020.07.07	<p>Review focused on the adverse consequences of the market disruption associated with the COVID-19 pandemic. While the review concentrated on CRE lending, including multifamily, the review also considered the status and performance of all loan portfolios.</p> <p>SR # 04-2020-1: Loan Analysis Worksheets-Borrowing Entity Description Analysis <i>Description:</i> Identify and analyze borrowing entity distinct from principals or guarantors. <i>Closed:</i> Closed prior to December 31, 2022.</p>
SL #05-2020 <i>IT Part I</i>	2020.07.29	Review evaluated both the Audit and Management rating components of the Uniform Rating System for Information Technology, as well as business continuity management, which is part of the Support and Delivery component.
SL #06-2020 <i>Operations Risk</i>	2020.08.26	Review focused on operations and processes particularly relevant to First Republic's continued growth and the changing business conditions associated with the COVID-19 pandemic.

Target Review / Supervisory Letter	Date Issued	Review Description / Supervisory Recommendations (SRs) and Matters Requiring Board Attention (MRBAs) (if any)
SL #07-2020 <i>Deposit Stability</i>	2020.11.02	Review focused on the impact of the COVID-19 pandemic on depositor behavior and various elements of the liquidity position, as well as actions taken by management to mitigate liquidity risk.
SL #08a-2020 <i>Private Wealth Management</i>	2020.11.02	Review assessed the risks and opportunities presented by the PWM business to the broader banking enterprise, including: Wealth Manager Acquisition and Stability; Errors, Complaints, and Resolutions; Pandemic Impact and Management; Eagle Alternatives Platform; First Republic Founders Index and FRC Founders Index Fund
SL #08b-2020 <i>Trust Services</i>	2020.12.03	The review assessed the components of the Uniform Interagency Trust Rating System including: Management; Operations, Internal Controls, and Audit; Compliance; Asset Management; and Earnings.
SL #09-2020 <i>IT Part II</i>	2020.12.17	Review evaluated both the Development and Acquisition and Support and Delivery components of the Uniform Rating System for Information Technology, except for business continuity management, which was reviewed earlier in the year.
SL #10-2020 <i>Retail Lending</i>	2020.12.10	Review assessed the credit quality of retail loan portfolios, which include the following: Single-family Residential; Home Equity Lines of Credit; Owner-occupied SFR Construction; and Student Loan Refinance, including its successor product, Personal Line of Credit.
SL #11-2020 <i>BSA / AML</i>	2020.12.17	Review covered the BSA/AML, fraud, and Office of Foreign Assets Control programs. The review encompassed an understanding of First Republic's risks associated with these areas, and reviewed management oversight, internal controls, audit coverage, and training designed to identify, manage, monitor, and control such risks.
2020 ROE	2021.05.05	2020 Report of Examination
2021 Examination Cycle		
SL #01-2021 <i>Commercial Lending</i>	2021.03.24	Review assessed the credit quality of commercial loan portfolios, which include the Business Loan Industry Segments: Commercial and Industrial; Capital Call Lines of Credit; Commercial Unsecured; Tax Exempt; and Eagle One.
SL #02-2021 <i>IT Part I</i>	2021.05.24	Review evaluated the Audit, Management, and Support and Delivery rating components of the Uniform Rating System for IT.
SL #03-2021 <i>Corporate Governance</i>	2021.05.24	Review assessed the scalability and efficiency of the Enterprise Risk Management Program and the people risk associated with talent management and leadership succession.
SL #04-2021 <i>Stress Testing</i>	2021.06.17	Review focused on several evolving elements of First Republic's stress testing program. The assessment included a broad view of the Model Risk Management program including Board and senior management oversight, policies and procedures, staffing, risk identification and reporting, and issues tracking mechanisms. SR # 04-2021-1: <i>Deposit Outflow Calibration Model Uncertainty and Stress Magnitude</i> <i>Description:</i> Management should account for the Deposit Outflow Calibration Model's uncertainty and stress magnitude. <i>Closed:</i> Closed in the 2022 Market and Funding Risk Target Review.
SL #05-2021 <i>Secured Commercial Lending</i>	2021.07.01	Review assessed the credit quality of secured commercial lending loan portfolios: Commercial Real Estate; Multifamily; Commercial Construction; and, Speculative Single-family Residential Construction.
SL #06-2021 <i>Operations Risk</i>	2021.08.23	Review assessed the adequacy of internal routines and controls processes relating to operational risks.
SL #07-2021 <i>Deposit Stability</i>	2021.10.27	Review assessed sensitivity to market risk, interest rate risk, model risk, deposit volume and trends, investment portfolio quality, and risk management practices in each area.
SL #09a-2021 <i>Private Wealth Management</i>	2021.11.22	Review assessed Private Wealth Management operations, PWM Business plan, investment strategy, Foreign Exchange risk, and risk management practices in each area, to evaluate the risk that PWM activities pose to the safety and soundness of the institution.
SL #09b-2021 <i>First Republic Trust Company</i>	2021.12.13	Review assessed all components of the Uniform Interagency Trust Rating System: Management, Operations, Internal Controls, and Audit, Earnings, Compliance, and Asset Management.

Target Review / Supervisory Letter	Date Issued	Review Description / Supervisory Recommendations (SRs) and Matters Requiring Board Attention (MRBAs) (if any)
SL #10-2021 <i>Retail Lending</i>	2021.11.30	Review assessed the credit quality of the following retail loan portfolios: Single-family Residential; Owner-occupied SFR Construction; and, Securities-based Lines of Credit.
SL #11-2021 <i>BSA / AML</i>	2021.12.13	Review assessed the BSA/AML and Office of Foreign Assets Control (OFAC) programs, including all supporting pillars. The review focused on changes to the programs made since the prior review and included the various systems and processes required to monitor and control risk arising from fraud, money laundering, and other illicit activity.
2021 ROE	2022.05.03	2021 Report of Examination
2021 Compliance ROE <i>Compliance</i>	2021.12.31	FDIC Compliance MRBA <i>Description:</i> The process of self-identifying and implementing full corrective action was informal and largely ineffective during the review period. <i>Closed:</i> MRBA was open at the time of First Republic's failure. Fair Lending MRBA <i>Description:</i> Disparities in residential lending within majority-Hispanic and majority-Asian census tracts in several of First Republic's market areas should be more effectively addressed and performance improved. <i>Closed:</i> MRBA was open at the time of First Republic's failure.
2022 Examination Cycle		
SL #01-2022 <i>Retail Lending</i>	2022.03.16	Review assessed the credit quality of retail loan portfolios, including the Single-family Residential, and Home Equity Lines of Credit products, and various Eagle loan products including Personal Lines of Credit, Eagle Gold, and Student Loan Refinancing.
SL #02-2022 <i>IT Part I</i>	2022.06.01	Review evaluated the Audit, Management, Development and Acquisition, and Support and Delivery rating components of the uniform Rating System for IT.
SL #03-2022 <i>Corporate Governance</i>	2022.05.12	Review assessed the adequacy of the data governance program and enterprise data management pertaining to data-related risks.
SL #04-2022 <i>Commercial Lending</i>	2022.06.29	Review assessed the credit quality of commercial loan portfolios, which included the following Business Banking industry segments: capital call lines of credit; tax exempt/ not-for-profit; commercial and industrial; and commercial unsecured.
SL #05-2022 <i>Operations Risk</i>	2022.09.13	Assessed the effectiveness of internal routines and controls over operational risk. Examiners evaluated processes and transaction tested data accuracy and controls.
SL #06-2022 <i>Market & Funding Risk</i>	2022.10.14	Review reflects the consolidation of two reviews – Stress Testing and Deposits Stability. Review assessed capital planning and stress testing, the Liquidity Stress Test and deposit stability models, Asset Liability Management models, and investment portfolio composition and risk management. SR # 06-2022-1: <i>Treasury Team Reporting of Substantive Model Changes for Independent Validation</i> <i>Description:</i> Treasury team should update ongoing monitoring policies and procedures related to models to ensure no substantive model changes are implemented in production prior to approval. <i>Closed:</i> Supervisory recommendation was open at the time of First Republic's failure. SR # 06-2022-2: <i>2LOD Effective Challenge in Response to Substantive Model Changes</i> <i>Description:</i> Update the Model Risk Management policy to clarify documentation and reporting of policy exceptions for substantive changes to models in production, and to require additional control mechanisms for policy exceptions. <i>Closed:</i> Supervisory recommendation was open at the time of First Republic's failure.
SL #07-2022 <i>First Republic Trust Company</i>	2022.12.08	Assessed all components of the Uniform Interagency Trust Rating System; Management; Operations, Internal Controls, and Audit; Earnings; Compliance; and Asset Management.

Target Review / Supervisory Letter	Date Issued	Review Description / Supervisory Recommendations (SRs) and Matters Requiring Board Attention (MRBAs) (if any)
SL #08-2022 <i>Secured Commercial Lending</i>	2022.12.12	Assessed credit quality of secured commercial lending portfolios: Commercial Real Estate, Multifamily, and Construction.
SL #09-2022 <i>AML CFT & OFAC</i>	2022.12.12	Review assessed the effectiveness of First Republic's AML/CFT and Office of Foreign Assets Control (OFAC) programs, focusing on changes to the programs made since the prior review and included the various systems and processes required to monitor and control risk arising from money laundering, terrorist financing, and fraud.
2023 Examination Cycle		
SL #01-2023 <i>Retail Lending</i>	Not dated	Review assessed the credit quality of retail loan portfolios, including Single-family Residential, Non-Owner Occupied SFR for Investment, Home Equity Lines of Credit, Eagle loan Personal Lines of Credit, and Securities-based Loans.

APPENDIX IV: ACRONYMS AND ABBREVIATIONS

Acronym / Abbreviation	Long Form
AFS	Available-for-sale securities
ALLL	Allowance for Loan and Lease Losses
ALM	Asset/Liability Management
AOCI	Accumulated Other Comprehensive Income
ARM	Adjustable-Rate Mortgage
BSA / AML	Bank Secrecy Act / Anti Money Laundering
BBR	Bank Board Resolution
CAMELS	Capital adequacy, Asset quality, Management capabilities, Earnings sufficiency, Liquidity position, Sensitivity to market risk
CEP	Continuous Examination Program
CMS	Compliance Management System
Cotton	Cotton & Company Assurance and Advisory, LLC
CRE	Commercial Real Estate
CRO	Chief Risk Officer
DERM	Director's Enterprise Risk Management
DFAST	Dodd-Frank Act Stress Test
DFPI	(California) Department of Financial Protection and Innovation
DIF	Deposit Insurance Fund
EIC	Examiner-in-Charge
EVE	Economic Value of Equity
FDI Act	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FHLB	Federal Home Loan Bank
FRCB	New York Stock Exchange ticker symbol for First Republic Bank
GAAP	U.S. Generally Accepted Accounting Principles
HQLA	High Quality Liquid Assets
HTM	Held-to-Maturity securities
IG	Inspector General
IPO	Initial Public Offering
LBS	Large Bank Supervision
LIDI	Large Insured Depository Institution
LST	Liquidity Stress Testing
MLR	Material Loss Review
MOU	Memoranda of Understanding
MRBA	Matter Requiring Board Attention
MRM	Model Risk Management
MVE	Market Value of Equity
NII	Net Interest Income
NPS	Net Promoter Score
NPV	Net Present Value
OCC	Office of the Comptroller of the Currency
OFAC	Office of Foreign Assets Control
OGM	Ongoing Monitoring (quarterly reports)

OIG	Office of Inspector General
PCA	Prompt Corrective Action
PE/VC	Private Equity / Venture Capital
PWM	Private Wealth Management
RADD	Regional Automated Document Distribution & Imaging System
RAS	Risk Appetite Statement
RMS	Division of Risk Management Supervision
ROE	Report of Examination
SBNY	Signature Bank of New York
SEC	U.S. Securities and Exchange Commission
SFR	Single Family Residential loans
SFRO	FDIC San Francisco Regional Office
SL	Supervisory Letter
SMR	Sensitivity to Market Risk
SR	Supervisory Recommendation
SVB	Silicon Valley Bank
UDAP	Unfair, Deceptive, or Abusive Acts or Practices
UFIRS	Uniform Financial Institutions Rating System
UPBR	Uniform Bank Performance Report
VISION	Virtual Supervisory Information On the Net

Part II

FDIC Comments and OIG Evaluation

On November 15, 2023, the FDIC Director of RMS provided a written response to a draft of this report. The response is presented in its entirety beginning on page II-2. In its response, the FDIC agreed with the findings and concurred with all 11 recommendations in the report. The FDIC's proposed corrective actions and its actions taken to date were sufficient to address the intent of the recommendations. The FDIC plans to complete all corrective actions for the recommendations by July 31, 2024. Therefore, we consider all 11 recommendations to be resolved.

The FDIC completed corrective actions on three recommendations prior to the issuance of this report. The other recommendations in this report will remain open until we confirm that corrective actions have been completed and the actions are responsive. A summary of the FDIC's corrective actions begins on page II-8.



Federal Deposit Insurance Corporation
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Division of Risk Management Supervision

November 15, 2023

TO: Terry L. Gibson
Assistant Inspector General for Audits, Evaluations, and Cyber
Office of Inspector General

FROM: Doreen R. Eberley
Director, Division of Risk Management Supervision

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Date: 2023.11.15 14:55:05
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SUBJECT: FDIC Response – Draft Material Loss Review of First Republic Bank

Thank you for the opportunity to comment on the draft report, *Material Loss Review of First Republic Bank* (Report). We appreciate the efforts of the FDIC's Office of Inspector General and its contractor, Cotton & Company Assurance and Advisory LLC in producing the report and in formulating its recommendations for the FDIC to improve supervisory processes.

The report states that "First Republic's (the Report's short form name for the bank) failure was caused by contagion effects stemming from the failure of other prominent financial institutions, which led to a run on deposits, depleting its liquidity and exposing weaknesses in First Republic's business strategy. Specifically, First Republic's strategy of attracting high net-worth customers with competitive loan terms, and funding growth through low cost deposits, resulted in a concentration in uninsured deposits while increasing the bank's sensitivity to interest rate risk in a rising rate environment. This strategy ultimately led to a significant asset/liability mismatch for the bank, and fair value declines on its portfolio of low-yielding, long-duration loans limited its ability to obtain significant liquidity and prevented its recovery."

The Report provided observations and findings related to FDIC's supervision of First Republic, including that the FDIC assessed the bank's uninsured deposits consistently with its policies, but that the significance and speed of uninsured deposit outflows warrants the FDIC's re-evaluation of those policies. Moreover, the Report states that the FDIC determined that First Republic was well capitalized throughout each examination cycle based on defined capital measures, but suggests that the bank's failure may warrant changes to the safety and soundness guidelines.

The Report also indicated that the FDIC missed opportunities to downgrade two component ratings and take earlier supervisory action. More specifically, the Report noted that the Liquidity component rating merited a downgrade from a "1" to a "2" after examiners identified increasing liquidity risks in the third and fourth quarter of 2022. Additionally, the Report indicated that First Republic's noncompliance with its own interest rate risk management framework, including its asset/liability mismatch and risk appetite statement breaches for three consecutive quarters and failure by the bank to take appropriate corrective action, merited a downgrade in the Management component rating from a "1" to a "2" and an issuance of a Matter Requiring Board Attention pertaining to Management and Sensitivity to Market Risk.

The FDIC agrees with the Report's findings and notes that they are consistent with the September 8, 2023 report by the FDIC's Chief Risk Officer, entitled, *FDIC's Supervision of First Republic Bank* (CRO Report).¹ The FDIC concurs with the eleven recommendations contained in the Report, and as described in the responses to each recommendation below, has already issued examiner guidance and taken other measures responsive to some of the recommendations, while other efforts are in process.

Recommendation 1: Evaluate why large-bank examination teams may wait to issue CAMELS ratings downgrades until issuance of Reports of Examination (ROEs), rather than promptly when circumstances warrant it as required by the RMS *Continuous Examination Process Procedures*. Then, take corrective action as appropriate.

The FDIC concurs with this recommendation. On August 30, 2023, the FDIC issued instructions to large bank examination teams via a regional director memorandum (RD Memo) entitled *Changes to Required Processes for FDIC-supervised Banks Subject to the Continuous Examination Process (CEP)* that recognizes that serious problems can manifest quickly, particularly in large, publicly traded banks, and these problems can impact the condition of banks. Among other things, the RD memorandum requires large bank Examiners-in-Charge (EICs) to document their assessment of all CAMELS component and composite ratings in quarterly ongoing monitoring reports. The FDIC will evaluate the efficacy of this new policy over the coming supervisory cycle to determine whether and if so, why large bank examination teams are waiting to issue rating downgrades until issuance of the Report of Examination. This evaluation will be completed by July 31, 2024 and will be documented through a memorandum from staff to the Director, Division of Risk Management Supervision, which will include corrective actions, if appropriate.

Recommendation 2: Identify additional communications or adjustments to training curriculum to reemphasize to examiners the importance of timely ratings changes in accordance with the FDIC's approach to forward-looking supervision.

The FDIC concurs with this recommendation. The FDIC conducted training on the RD Memo discussed in the response to recommendation 1 on October 4, 2023, which amplified the RD Memo's message about the importance of timely ratings changes to large bank examination teams. The FDIC will review the examiner training curriculum to identify whether additional adjustments might need to be made and will document that review through a memorandum from staff to the Director, Division of Risk Management Supervision by May 31, 2024.

¹ <https://www.fdic.gov/news/press-releases/2023/pr23073a.pdf>

Recommendation 3: Evaluate and update as appropriate examination guidance to require specified supervisory actions when a bank's business practices do not align with its policies and procedures (e.g., a balance sheet position that does not align with its interest rate policy).

The FDIC concurs with this recommendation. The FDIC will review its examination guidance to determine whether it needs to be enhanced to specifically highlight and address situations where a bank's condition or operations do not align with its policies and procedures, and will make recommendations for enhancements as appropriate. Such a review will be documented through a memorandum from staff to the Director, Division of Risk Management Supervision, by May 31, 2024.

Recommendation 4: Evaluate and update as appropriate examination guidance to require specified supervisory actions when a bank does not take timely and appropriate action when it violates its risk-appetite statement (RAS) metrics (e.g., successive economic value of equity [EVE] breaches without corrective action by First Republic).

The FDIC concurs with this recommendation and has completed the action. The RD Memo described in recommendation 1 sets forth protocols for communications regarding risk tolerance breaches, risk limit increases, and other material risk factors during the large bank supervision process. More specifically, large bank EICs are responsible for communicating to the appropriate case manager breaches in key internal bank risk tolerances or material changes in those key risk limits or risk appetite, as well as what actions bank management has or will take to address those breaches. In the RD Memo, case managers are directed to report these events to Regional Office and Washington Office management in accordance with existing procedures for communicating significant events set forth in the internal Case Manager Procedures.

Recommendation 5: Comprehensively re-evaluate the Manual to determine whether updates to examination guidance are needed pertaining to evaluation of the stability of uninsured deposits, including the potential effectiveness of mitigating factors.

The FDIC concurs with this recommendation and has completed the action. On October 24, 2023, the FDIC updated the Report of Examination Instructions in the *Risk Management Manual of Examination Policies*² to specifically require written analysis of the risk management practices followed by bank management for uninsured deposit concentrations of 50 percent or more of total deposits. This section of the Manual was also updated with the following new instruction, which qualifies the potential effectiveness of mitigating factors:

“However, these characteristics may not prevent uninsured depositors from suddenly withdrawing funds to shield themselves from significant losses in the event an institution exhibits financial difficulties or receives negative publicity. When assessing uninsured deposit stability, examiners should consider the bank's business model, risk profile, and complexity; the potential impact to the balance sheet; and management's ability to

² <https://www.fdic.gov/regulations/safety/manual/section16-1.pdf>

identify, measure, monitor, and control the risks of the concentration, including during times of stress. In addition, circumstances may warrant separately identifying the insured deposits of certain depositors with significant uninsured deposits if entire deposit relationships are subject to instability.”

Recommendation 6: Comprehensively re-evaluate the Manual to determine whether updates to examination guidance are needed pertaining to the evaluation of banks’ deposit outflow assumptions for liquidity stress testing, including the speed and velocity of uninsured deposit outflows.

The FDIC concurs with this recommendation. In consideration of this recommendation, and consistent with the matters for consideration and study included in the FDIC Chief Risk Officer’s April 28, 2023 Report, *FDIC’s Supervision of Signature Bank*, the FDIC conducted such an evaluation and determined to update the Liquidity section of the Manual to expand the discussion of the volatility of uninsured deposits and the importance of contingency funding plan considerations. This action will be completed by December 31, 2023.

Recommendation 7: Comprehensively re-evaluate examination guidance to determine whether updates are needed in the area of: Proactive horizontal identification and monitoring of similarities across banks – including like business characteristics and risks, and like reputational characteristics – that may result in similar behaviors amongst their depositors, including shared risk characteristics that may result in increased contagion risk between institutions.

The FDIC concurs with this recommendation. The FDIC will conduct a review to determine whether additional examination guidance is needed regarding identification and monitoring of similarities in risk factors across banks that could result in similar behaviors amongst depositors, and ultimately, could give rise to contagion risk. This review will be documented through a memorandum from staff to the Director, Division of Risk Management Supervision by May 31, 2024.

Recommendation 8: Comprehensively re-evaluate examination guidance to determine whether updates are needed in the area of: Incorporating shared risk characteristics that may result in increased contagion risk between institutions into the FDIC’s supervisory approach across large institutions.

The FDIC concurs with this recommendation. The FDIC will review examination guidance to determine whether updates are needed regarding the supervisory approach to large institutions that share risk characteristics that may result in increased contagion risk. This review will be documented through a memorandum from staff to the Director, Division of Risk Management Supervision by May 31, 2024.

Recommendation 9: We recommend that the Director, Division of Risk Management Supervision: Implement the following matter for further study of the FDIC Chief Risk Officer in its report *FDIC’s Supervision of First Republic Bank*: Explore potential processes and

information sources for real-time monitoring of large bank reputational risk. Potential information sources could include bank share price tracking websites, short seller activity, and social media discussions.

The FDIC concurs with this recommendation. The FDIC will explore processes and sources of information that might facilitate monitoring of large bank liquidity risk that could arise from sources such as short seller activity and negative social media references. The results of this exploration will be documented through a memorandum from staff to the Director, Division of Risk Management Supervision by May 31, 2024.

Recommendation 10: As the regulators update and finalize the proposed rule modifying large bank Capital requirements, we recommend that the Director, Division of Risk Management Supervision: Implement the matter for further study from the Chief Risk Officer to evaluate whether Continuous Examination Process (CEP) examination teams should place greater consideration and emphasis on unrealized losses and declines in fair value (in both securities and loans).

The FDIC concurs with this recommendation and has completed the action. Starting in the first quarter 2022, the FDIC added to the FDIC's quarterly supplemental offsite review list institutions that may be susceptible to high levels of net unrealized holding losses on debt securities due to increasing interest rates. By adding these institutions to the quarterly offsite review list process, existing instructions set forth in the internal Case Manager Procedures require case managers to assign a level to the risk of high levels of net unrealized losses on debt securities, the trend of the risk, and to set a supervisory strategy for the risk. Refresher training on the offsite review process was conducted for case managers on May 25, 2023. Additionally, on April 12, 2023, the FDIC issued an RD Memo entitled *Supplemental Activities for Institutions with Significant Exposure to Net Unrealized Losses on Debt*, which among other things, centralizes resources to help examiners and case managers assess the impact of rising interest rates on affected institutions.

Risks related to declines in fair values of loans are more challenging to assess, as fair values are only required to be reported by publicly traded institutions, and those values are estimates. Nevertheless, beginning in the first quarter of 2023, the FDIC added a measure for long term loans to the offsite review list flagging process to capture those institutions that may be more likely to have lower fair values in the current rate environment.

Recommendation 11: Engage with other federal regulators to evaluate the need for changes to rules under the safety and soundness standards, including the adoption of noncapital triggers that would require early and forceful regulatory actions tied to unsafe banking practices before they impair capital.

The FDIC concurs with this recommendation and will engage with the other regulators to evaluate whether changes to the regulations³ promulgated under section 39 of the FDI Act⁴ may be warranted to address noncapital triggers to take actions related to unsafe and unsound practices. The FDIC will document the results of that engagement and evaluation with the other regulators by March 31, 2024.

³ <https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-364>

⁴ <https://www.fdic.gov/regulations/laws/rules/1000-4100.html#fdic1000sec.39>

Summary of the FDIC's Corrective Actions

This table presents management's response to the recommendations in the 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: ^a Yes or No	Open or Closed ^b
1	<p>In August 30, 2023, the FDIC issued instructions to large bank examination teams via a regional director memorandum (RD Memo) entitled <i>Changes to Required Processes for FDIC-supervised Banks Subject to the Continuous Examination Process (CEP)</i> that recognizes that serious problems can manifest quickly, particularly in large, publicly traded banks, and these problems can impact the condition of banks. Among other things, the RD Memo requires large bank Examiners-in-Charge (EIC) to document their assessment of all CAMELS component and composite ratings in quarterly ongoing monitoring reports.</p> <p>The FDIC will evaluate the efficacy of this new policy over the coming supervisory cycle to determine whether, and if so, why large bank examination teams are waiting to issue rating downgrades until issuance of the Report of Examination. This evaluation will be documented through a memorandum from staff to the Director, Division of Risk Management Supervision (RMS) and include corrective actions, if appropriate.</p>	July 31, 2024	\$0	Yes	Open
2	<p>The FDIC conducted training on the RD Memo discussed in the response to recommendation 1 on October 4, 2023, which amplified the RD Memo's message about the importance of timely ratings changes to large bank examination teams. The FDIC will review the examiner training curriculum to identify whether additional adjustments are necessary and will document that review through a memorandum from staff to the Director, RMS.</p>	May 31, 2024	\$0	Yes	Open

Summary of the FDIC's Corrective Actions

3	The FDIC will review its examination guidance to determine whether it needs to be enhanced to specifically highlight and address situations where a bank's condition or operations do not align with its policies and procedures, and will make recommendations for enhancements as appropriate. The review will be documented through a memorandum from staff to the Director, RMS.	May 31, 2024	\$0	Yes	Open
4	The RD Memo described in recommendation 1 sets forth protocols for communications regarding risk tolerance breaches, risk limit increases, and other material risk factors during the large bank supervision process. Large bank EICs are responsible for communicating to the appropriate case manager breaches in key internal bank risk tolerances or material changes in those key risk limits or risk appetite, as well as what actions bank management has or will take to address those breaches. The RD Memo directs case managers to report these events to Regional Office and Washington Office management in accordance with existing procedures.	August 30, 2023	\$0	Yes	Closed
5	On October 24, 2023, the FDIC updated the Report of Examination Instructions in the <i>Risk Management Manual of Examination Policies</i> to specifically require written analysis of the risk management practices followed by bank management for uninsured deposit concentrations of 50 percent or more of total deposits. This Manual section was also updated with new instructions, which qualify the potential effectiveness of mitigating factors.	October 24, 2023	\$0	Yes	Closed
6	In consideration of this recommendation, and consistent with the matters for consideration and study included in the FDIC Chief Risk Officer's April 28, 2023 Report, <i>FDIC's Supervision of Signature Bank</i> , the FDIC conducted an evaluation and determined it was appropriate to update the Liquidity section of the Manual to expand the discussion of the volatility of uninsured deposits and the importance of contingency funding plan considerations.	December 31, 2023	\$0	Yes	Open

Summary of the FDIC's Corrective Actions

7	The FDIC will conduct a review to determine whether additional examination guidance is needed regarding identification and monitoring of similarities in risk factors across banks that could result in similar behaviors amongst depositors, and ultimately, could give rise to contagion risk. This review will be documented through a memorandum from staff to the Director, RMS.	May 31, 2024	\$0	Yes	Open
8	The FDIC will review examination guidance to determine whether updates are needed regarding the supervisory approach to large institutions that share risk characteristics that may result in increased contagion risk. This review will be documented through a memorandum from staff to the Director, RMS.	May 31, 2024	\$0	Yes	Open
9	The FDIC will explore processes and sources of information that might facilitate monitoring of large bank liquidity risk that could arise from sources such as short seller activity and negative social media references. The results of this exploration will be documented through a memorandum from staff to the Director, RMS.	May 31, 2024	\$0	Yes	Open
10	<p>Starting in first quarter 2022, the FDIC added to the FDIC's quarterly supplemental offsite review list institutions that may be susceptible to high levels of net unrealized holding losses on debt securities due to increasing interest rates. Existing instructions require case managers to assign a level to the risk of high levels of net unrealized losses on debt securities, the trend of the risk, and to set a supervisory strategy for the risk. Refresher training on the offsite review process was conducted for case managers on May 25, 2023.</p> <p>Additionally, on April 12, 2023, the FDIC issued an RD Memo entitled <i>Supplemental Activities for Institutions with Significant Exposure to Net Unrealized Losses on Debt</i>, which among other things, centralizes resources to help examiners and case managers assess the impact of rising interest rates on affected institutions.</p>	May 25, 2023	\$0	Yes	Closed

Summary of the FDIC's Corrective Actions

	Also, despite current challenges in assessing declines in the fair value of loans, beginning in the first quarter of 2023, the FDIC added a measure for long-term loans to the offsite review list flagging process to capture those institutions that may be more likely to have lower fair values in the current rate environment.				
11	The FDIC will engage with the other regulators to evaluate whether changes to the regulations promulgated under Section 39 of the FDI Act may be warranted to address noncapital triggers to take actions related to unsafe and unsound practices. The FDIC will document the results of that engagement and evaluation with the other regulators.	March 31, 2024	\$0	Yes	Open

^a Recommendations are resolved when —

1. Management concurs with the recommendation, and the OIG agrees the planned corrective action is consistent with the recommendation.
2. Management does not concur or partially concurs with the recommendation, but the OIG agrees that the proposed corrective action meets the intent of the recommendation.
3. For recommendations that include monetary benefits, management agrees to the full amount of OIG monetary benefits or provides an alternative amount and the OIG agrees with that amount.

^b Recommendations will be closed when the OIG confirms that corrective actions have been completed and are responsive.



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The OIG's mission is to prevent, deter, and detect waste, fraud, abuse, and misconduct in FDIC programs and operations; and to promote economy, efficiency, and effectiveness at the agency.

To report allegations of waste, fraud, abuse, or misconduct regarding FDIC programs, employees, contractors, or contracts, please contact us via our [Hotline](#) or call 1-800-964-FDIC.

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