Decision of the
Supervision Appeals Review Committee

<u>Case No. 2010-03</u>

I. Summary of Findings.

After consideration of the timely filed written submissions of the parties, the record of this case, and following the June 16, 2010 deliberative meeting of this Committee, we have denied the Bank's appeal. For the reasons set forth in this decision, the Committee finds that the Capital, Asset Quality, Management, and Earnings Component Ratings and the Composite Rating are well founded and that the supervisory determinations limiting balance-sheet growth and prohibiting the purchase of corporate bonds, properly imposed. The Committee finds that the supervisory determinations contained in the September 2009 joint examination and related correspondence are fully consistent with FDIC policy and examiner guidance.

II. Background.

This appeal arises from disputed material supervisory determinations set forth in the joint examination ("ROE," or the "Joint Exam") conducted together by the FDIC's *** Regional Office (the "Regional Office") and the state regulator (the "State"). The Joint Exam, which started on September 8, 2009 and used financial information as of June 30, 2009, resulted in CAMELS ratings of 333422/3.[1] On February 10, 2010, *** Bank, ***, *** (the "Bank") filed a Request for Review (the "Request") with the Director (the "Director") of the Division of Supervision and Consumer Protection ("DSC," or the "Division"). The Bank contested its Composite rating and its Capital, Asset Quality, Management, and Earnings Component Ratings. Additionally, it argued that the two supervisory determinations issued by the Regional Office on December 17 and December 23, 2009 (the "December Restrictions"), limiting balance-sheet growth and prohibiting the purchase of corporate bonds, were unwarranted.

On March 16, 2010, the Director affirmed the decision of the Regional Office, determining that the safety and soundness ratings were consistent with FDIC policy and existing examination guidance, and appropriate, given the facts available at the time of the Joint Exam. The Director further found the Regional Office's December Restrictions appropriate and compliant with FDIC policy.

The Bank timely filed an appeal with the Supervision Appeals Review Committee (the "Committee") by letter dated April 1, 2010. The Bank contests the "3" ratings for both Capital Adequacy and the Asset Quality, seeking upgrades in both cases to ratings of "1." It also disputes the Management rating of "3," the Earnings rating of "4," and the

[1] Capital "3," Asset Quality "3," Management "3," Earnings "4," Liquidity "2," Sensitivity to Risk "2," and Composite "3."

Composite rating of "3," requesting upgrades of one level in each of these categories. Finally, the Bank disputes the Director's determinations limiting balance-sheet growth and prohibiting the purchase of corporate bonds, seeking rescission of both of those measures.

A. Statement of Facts and Timeline.

The Bank is a state savings bank with total assets as of June 30, 2009, of $** million. The Bank has one office in ***, ***, in suburban ***. The Bank formerly operated as the ***, and was established in **** as a state-chartered commercial bank. The Federal Reserve Bank of *** ("FRB") approved a change-of-control application at the bank holding company, under which the principal shareholder, *** ("Mr. X"), acquired 100% of the holding company stock. Mr. X is the president and founding partner of *** ("XYZ"), a *** investment firm and hedge fund. Mr. X informed the FRB, the state regulator, and the FDIC of a proposed change in the Bank's business plan (the "Business Plan," or the "Plan") to aggressively grow the institution from $** million in total assets to over $1 billion in assets in one year, to be centered in syndicated loans, and to be funded by brokered deposits and FHLB advances.

As the proposed change in the Business Plan was not disclosed in the change-of-control application, the FRB initiated a substantive review of the proposed Plan. During the FRB's review of the Bank's Business Plan, the Bank's management notified the FRB of the Bank's intention to liquidate the bank holding company and expedite the execution of the proposed Business Plan.

The FDIC wrote to the Bank, expressing its risk-management and compliance/Community Reinvestment Act ("CRA") concerns in connection with the proposed Business Plan changes:

> We must reiterate our concerns with the Plan, as discussed with President *** and Majority Owner *** at a meeting held in the Regional Office on ***. The Plan continues to be premised on <u>substantial</u>, rapid asset growth funded primarily by borrowings and wholesale (brokered) deposits. Management expertise is unproven in managing risks associated with this strategy in a regulated banking environment, and adequacy of the proposed capital structure is questionable given the perceived increased risk profile of the bank. We encourage caution in your consideration of the proposed Plan.
>
> We will continue to closely monitor the bank's growth, operations, and risk exposures, both via offsite reporting mechanisms, and during the next on-site examination, which is tentatively scheduled to commence prior to year-end.

Letter from Deputy Regional Director *** to the Bank board of directors (emphasis in original).

Later, however, the state regulator approved the Bank's application to convert to a savings bank and simultaneously approved the change in Business Plan, but on three conditions, under which the Bank was required to:

1. Maintain a Tier 1 leverage ratio of *% and total risk-based capital ratio of **%;
2. Maintain a maximum classified asset ratio of **% of Tier 1 plus Tier 2 capital; and
3. Maintain effective procedures for the Allowance for Loan and Lease Losses ("ALLL").

The Bank was converted to a state savings bank; its name was changed to ***; Mr. X injected $** million into the Bank as capital; the holding company was dissolved; and the Business Plan was executed. The change in Business Plan was approved neither by the FRB nor by the FDIC. The Plan, as approved by the state regulator and subject to the three conditions, focused on aggressive growth through the purchase of syndicated loans, primarily consisting of Shared National Credits ("SNCs").[2] The Plan projected growth in total assets under various capital injection scenarios from $60 million to as much as $1.4 billion in one year.

A month later, the Regional Office met with the Bank's board, informing them that the new Business Plan was unacceptable. The Regional Office requested and received the board's commitment to halt growth and provide the FDIC with a revised plan for review and approval. However, at that meeting, the Bank's management disclosed they had already purchased $25 million in distressed assets funded by $15 million in long-term maturity brokered deposits. On December 10, 2008, Principal Shareholder X committed, by letter, to stop additional purchases of syndicated loans and brokered deposits.

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[2] The Shared National Credit Program was established in 1977 by the Board of Governors of the Federal Reserve System, the FDIC, and the Office of the Comptroller of the Currency (the "OCC") to provide an efficient and consistent review and classification of any large syndicated loan. Today, the program covers any loan or loan commitment, and any asset such as real estate, stocks, notes, bonds, and debentures taken as debts previously contracted, extended to borrowers of a federally supervised institution, its subsidiaries, and affiliates that aggregates to at least $20 million and is shared by three or more supervised institutions. Many of these large loan commitments are also shared with foreign banking organizations and nonbanks, including securitization pools, hedge funds, insurance companies, and pension funds. The agencies conduct an annual review, usually in May and June. References to analyses of SNCs in this opinion derive from those annual reviews.

On learning from the board that the Bank had already purchased $25 million in distressed assets, DSC instituted an offsite review as of December 31, 2008, which, in turn, triggered a follow-up visitation on June 15, 2009, at which time the Bank was downgraded to a Composite of "3" and a Memorandum of Understanding ("MOU") was presented to the board with the Visitation transmittal letter. Owing to the Composite downgrade, the institution's examination cycle was changed from an 18-month to a 12-month cycle. Accordingly, a joint exam was scheduled to start on September 8, 2009.

In an October 1, 2009 letter sent in response to DSC's and the State's June 15, 2009 Visitation and proposed MOU, the Bank informed DSC that it would not sign the proffered MOU and, instead discussed a new proposed Business Plan involving, among other things, the purchase of $15 million in corporate bonds and a reverse entry of the Bank's ALLL. On October 7, 2009, the FDIC Case Manager and state regulator Supervisor called the Bank's CEO *** to discuss the proposed changes. At that time, the CEO revealed that management had already purchased nearly $8 million in corporate bonds between September 15 and October 1, 2009. The FDIC and state regulator told the CEO to cease any further purchases of corporate bonds. However, the Regional Office determined to wait on the results of the upcoming results of the September Joint Exam to send the Bank a revised MOU, if necessary, based on more recent findings.

On October 20, 2009, in a joint letter to the Bank's board, the FDIC and the State directed the Bank to submit specific information on the Business Plan and how the Plan dealt with such issues as limits on investments in relation to capital; the pre-purchase analysis performed for the corporate bonds purchased as a part of the Plan; the impact of the Plan on interest-rate risk; and how the compliance management system would support the proposed growth envisioned by the Plan. The October 20, 2009 letter stipulated that the Bank should not move forward with the change in the Business Plan until the Bank received from the FDIC and the State a written response to the information to be submitted by the Bank. The letter also reiterated the instruction given the Bank's CEO by the October 7 telephone call of the FDIC Case Manager and the state regulator to the Bank directing it to cease any additional corporate bond purchases.

In response, the Bank refused, in a November 3, 2009 letter, to cease the purchase of corporate bonds. The Bank asserted in the November letter that it had ***not*** submitted a request to change its Business Plan. Rather, the Bank contended that, as the Bank was a growing institution and modifications of the Business Plan would be required from time to time to reflect that growth, "other than revisions by your offices or adjustments made to accommodate our growth, the Bank has not changed its business nor added new business activities that would constitute a change in plan from the original plan."

The results of the September 2009 Joint Exam were transmitted to the Bank on December 17, 2009. Along with the results of the September Joint Exam, a revised MOU (the "Revised MOU") was included for restoring the Bank to a satisfactory condition. The FDIC and the state regulator also initiated a conference call with the Bank's CEO

that day to discuss their regulatory concerns with respect to the Bank's November 3 refusal to discontinue their purchase of corporate bonds, noting the Bank's increased risk profile. In that call, the FDIC and the state regulator informed the Bank that the regulators would perform a targeted on-site visitation during first quarter 2010, focusing on the corporate bond portfolio and the proposed change in the Bank's Business Plan.

In a December 23, 2009 joint letter, the FDIC and the State once again instructed the Bank that its board of directors was to discontinue the purchase of corporate bonds. The December 23 joint letter also reiterated the regulators' concern over the Bank's increased risk profile growing out of the change in the Business Plan and additional bond purchases. The joint letter noted the scheduling of the targeted Visitation and a meeting with the entire board.

B. Summary of the Parties' Contentions.

The Bank argues that, in denying its Request, DSC: (1) ignored the true financial condition of the Bank; (2) failed to review all of the facts and circumstances as they existed before making their supervisory determinations; (3) consulted data following the June 30, 2009 cut-off date for financial information yet refused to consider such information that was favorable to the Bank; and (4) imposed the December Restrictions despite record evidence that the Bank had, in fact, established prudent limits in relation to its Tier 1 capital and decreased its reliance on brokered deposits.

Specifically, the Bank contends that, as of June 30, 2009, its Tier 1 capital ratio was over **% and had been so for the past four quarters, and that less than *% of its total net loans were past due by more than 30 days. Net income for 2009 was $**,*** as of the September Call Report and $***,*** as of the December 2009 Call Report, indicating an increasingly improved financial condition. The Bank also stressed that highly experienced personnel had been recruited for management's ranks, a fact that, it argued, undercut the unreasonably low Management rating given it by DSC in the Joint Exam. Further, the Bank's classified assets ratio was low in comparison to its peer group of institutions; the Bank's ALLL was conservatively funded and regulatory-compliant; $* million in brokered deposits had run off; and, as of June 30, 2009, the Tier 1 leverage capital ratio was **.**%, the Tier 1 risk-based capital ratio, **.**%, and the total risk-based capital ratio, **.**% (high compared to "well-capitalized" Prompt Corrective Action ratios of 5%, 6%, and 10%). Additionally, the Bank points to its performance in contrast to that of its peer group, noting that it is better capitalized than most of those peer institutions.

Finally, as to the December Restrictions, the Bank contends that DSC ignored significant and exhaustive information, supplied to DSC, supporting the Bank's investment policies. DSC's prohibition on the purchase of corporate bonds would necessarily lead to an unsafe and unsound condition, according to the Bank: the Bank's failure to deploy the excess cash derived from its successful campaign to increase core

deposits would unavoidably result in losses from the interest owing on those core deposits, producing an erosion of capital.

DSC disputes each of these claims, arguing that the Bank's assertions fail to account for the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control those risks. The Bank has experienced a significant decline in the credit quality and earnings since the previous examination. The Bank's evidence purporting to support higher component ratings, according to DSC, is insufficient, failing to take into account, as it does, the Bank's risk profile. Further, the Bank's argument on the necessity of purchasing even more potentially volatile assets could lead to further deterioration of its balance sheet. Bank management has executed a new business model posing excessive risk and resulting in material loan and investment losses. Earnings performance reveals persistent losses and the potential for future volatility.

DSC defends the imposition of the December Restrictions, arguing that the December 17 direction to limit balance-sheet growth was issued pursuant to a specific FDIC policy requiring enforcement of such limits on the appearance of certain benchmarks. The limits were imposed as interim measures until full corrective measures could be initiated. The Bank has experienced significant growth (**% in 2008 and **% in 2009) centered in riskier assets, making the measures both appropriate and necessary.

The December 23 prohibition on the purchase of corporate bonds, although unusual, is well justified by the equally unusual strategy embraced by this small community bank. DSC notes that the Bank's board had approved the purchase of lower investment-grade bonds to an excessive degree. In the normal course of business, such a portfolio would experience ratings changes, including downgrades. Such migration could result in subinvestment-quality holdings. Prudential concerns would counsel reasonable limits on investment-grade holdings as a part of the Bank's investment policy and Business Plan.

In accordance with the *Guidelines for Appeals of Material Supervisory Determinations* ("*Guidelines*"),[3] the Committee reviews for consistency with the policies, practices, and mission of the FDIC, and the reasonableness of and support for the positions of the parties. The Committee granted the Bank's request to appear at the June 16, 2010 Committee meeting. Under the *Guidelines*, the burden of proof on all matters at issue rests with the institution. The scope of the Committee's review is limited to the facts and circumstances existing at the time of the September 8, 2009 Joint Exam, which used financial information as of June 30, 2009. No consideration has been given to facts

[3] The FDIC's Board of Directors previously adopted amended *Guidelines* on September 17, 2008. *See* 73 Fed. Reg. 54,822 (September 23, 2008). This year, on April 13, 2010, the Board adopted revised *Guidelines*. *See* 75 Fed. Reg. 20,358 (April 19, 2010).

or circumstances that developed following the Exam in the Committee's findings on the component and composite ratings. Post Examination information was considered in the Committee's deliberations on the growth-limit supervisory determinations, as those determinations were made and involve actions taken following the Joint Exam.

C. A Preliminary Matter: The Period under Review for the September 9, 2009 Joint Exam.

Section M of the *Guidelines* provides in part: "SARC review will be limited to the facts and circumstances as they existed prior to or at the time the material supervisory determination was made, even if later discovered, and no consideration will be given to any facts or circumstances that occur or corrective action taken after the determination was made."

Citing the Washington Office review of the Bank's Request, the Bank argues in its appeal papers that the Division refused to consider information beyond the examination date that was favorable to the Bank, despite the fact that the DSC had reviewed post-June 30, 2009 information. And in fact, it is clear from the Bank's record citation that DSC *did* take notice of post-exam information:

> Although financial data submitted following the close of the 2009 Examination are not normally considered in assigning CAMELS ratings, the Regional Office did review the Bank's September 30, 2009 UBPR in the course of processing the 2009 Examination. These results were not sufficiently robust to warrant continuation of a "3" rating.

Response of the Director to the Bank's Request for Review (March 16, 2009), at p. 3.

The Bank reasons that DSC had in its possession but refused to consider facts justifying upgrades in both the component and composite ratings. Uniform Bank Performance Reports ("UBPR Reports") are based on Call Reports, the Bank notes, and must be compiled after the filing of Call Reports. Therefore, when DSC was finalizing the CAMELS ratings, it had full access to the Bank's September 30, 2009 Call Report, which constitutes "facts and circumstances that existed prior to or at the time the material supervisory determination[s] [were] made . . . ." The Bank concludes that that information should have been considered by DSC in reaching its determinations.

According to DSC, the Joint Examination was not received in the Regional Office following processing in the Field, until November 10, 2009, at which time, DSC had already received the September 30, 2009 UBPR Report. Under the Case Manager's Procedural Manual, case managers are required to review the most recent UBPR. That information ***was*** reviewed by DSC, but the addition of third-quarter 2009 performance, in terms of quality and sustainability, was not sufficient to overcome the conclusions in the

Joint Exam. Accordingly, DSC declined to take the highly unusual step of adjusting a rating assigned by an onsite examination based solely on a one-quarter change in the Bank's statistical performance.

The Committee's Findings. Under section M of the *Guidelines*, in the context of an appeal from examination findings, the Committee looks at two separate but related areas of "facts and circumstances." ***First***, the financial information on which an Exam is based must be complete, uniform, and audited. Hence, the financials for the end of the prior quarter, here, June 30, 2009, comprise the financial information supporting the Exam. This is the "as of" date and is identified on the front of every Exam. ***Second***, the material supervisory determinations (the ratings) made during the process of the Exam are made on the basis of those financials but also take into consideration the facts and circumstances as they exist and are revealed during the Exam, as specified in section M. The Exam itself is a process, generally lasting over a period of weeks. The date cutting off this period is generally established as the Exit Meeting, when the results of the Exam are communicated to the Bank, and the results are finalized on approval by the Regional Office. The Exit Meeting date is accordingly specified as "the time the material supervisory determination[s were] made." That date in this case is October 16, 2009.

The Committee finds that although under established internal procedures, case managers review the most recent UBPRs, such procedures cannot and do not overcome longstanding practice and the cardinal rule set out in the *Guidelines*. Section M of the *Guidelines* lays the foundation for a uniform period of consideration of all financial information and performance for all institution examinations. And those dates are closely observed by this Committee in establishing SARC precedent. The purpose of the "determination" date (for facts and circumstances as they exist at the time the determination was made), as well as the examination "as of" date (for audited financials) is to establish consistency and a fair playing field in the examination and rating of regulated institutions. To the extent that performance may trend upward after an exam has closed, evidence post-exam potentially demonstrating such a trend will be evaluated in the next exam. Similarly, negative trends discovered in the post-exam period will be included in the following exam, or as was the case with the Bank, evaluated at in interim Visitation, if necessary. Although DSC reviewed post-Exam financials in this case, it rejected those figures as insufficient evidence to rebut the examination conclusions evincing weak earnings and performance. The Bank was informed of that judgment and the reason justifying it in the Director's Response to the Bank's Request.

III. Analysis.

A. The Safety and Soundness Supervisory Determinations.

The Bank disputes its Composite rating, as well as its Component ratings for Capital, Asset Quality, Management, and Earnings. The Bank seeks a "1" for Capital, a

"1" for Asset Quality, a "2" for Management, a "3" for Earnings, and a Composite rating of "2."

1. Capital Adequacy.

Under the Federal Financial Institutions Examination Council's Uniform Financial Institutions Rating System (the "FFIEC Rating System"),[4] a financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. Capital Adequacy is based on an assessment of factors such as the level and quality of capital and the overall financial condition of the institution; the ability of management to address emerging needs for additional capital; the nature, trend, and volume of problem assets, and the adequacy of ALLL and other valuation reserves; balance sheet composition, including concentration risk and risks associated with nontraditional activities; the quality and strength of earnings; and prospects and plans for growth, as well as past experience in managing growth.

A ***Rating of 1*** indicates a strong capital level relative to the institution's risk profile.

A ***Rating of 2*** indicates a satisfactory level relative to the risk profile.

A ***Rating of 3*** indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

The Bank's Position. The Bank describes itself as a small $** million community bank and argues that the strength of its capital position can be found in its capital ratios. As of June 30, 2009, the Bank had reported **.**% Tier 1 leverage capital, a Tier 1 risk-based capital ratio of **.**%, and a total risk-based capital ratio of **.**%. The Bank asserts it has virtually no real estate loans, and fewer than 2% of its total net loans were past due by more than 30 days as of the June 30 date. The Bank contends that, not only do these ratios significantly exceed peer, they also surpass regulatory minimums. The Bank has had over **% Tier 1 capital for each of the last four quarters. The Bank's numbers compare favorably to the corresponding well-capitalized Prompt Corrective Action ("PCA") ratios of 5%, 6%, and 10%. As cited above, the Bank emphasizes its performance exceeds that of its peers in capital, pointing out that it is better capitalized than most of the peer group.

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[4] The FFIEC ratings descriptions in this opinion are taken from the FDIC's *Risk Management Manual of Examination Policies* but have been shortened for ease of reference. Full descriptions of each rating can be found at http://www.fdic.gov/regulations/safety/manual/index.html.

The Bank also disputes as overstated DSC's concerns regarding credit quality, suggesting that the Bank's capital ratios rightfully mitigate any credit quality risks. In the face of its capital numbers, the Bank dismisses the Division's attempts to justify the "3" rating. The ROE contention that capital is less than satisfactory in relation to the Bank's risk profile, the Bank finds baseless. In the Bank's view, the Joint Exam caution that "other factors exist" that may impair the capital base going forward "boil[s] down to the 'possibility' of realized losses from the sale of SNCs" and such a "possibility" is not a credible concern. Considering, the Bank asserts, that the entire SNC portfolio could have been liquidated for a gain of $150,000 as of the start of the June Visitation, or for $1.1 million as of the beginning of the September Joint Examination, DSC's apprehension is not fact-based. The Exam team failed to factor in the obvious market and financial improvements in the portfolio. From the beginning, the Bank argues, the only losses incurred in the SNC portfolio are those resulting from the Bank's compliance "with a regulatory requirement that the Bank maintain a **% classified assets ratio."

DSC's Position. Although the Bank reports capital ratios that currently exceed regulatory minimums, the Capital Adequacy rating, DSC argues, is based on a number of interconnected factors, including, *e.g.*, the nature, trend, and volume of problem assets, the adequacy of ALLL, and the prospects and plans for growth. The capital numbers the Bank cites and the fact that it is "better capitalized than [most] of its peers" under those numbers, take no risk factors into consideration in building and maintaining capital. DSC stresses that examiners are required to rate capital, not in absolute or quantitative terms but relative to the institution's unique risks and to management's ability to monitor and control those risks. Quantitative benchmarks such as PCA categories and peer group performance can be useful measurements, but a forward-looking approach examines an institution's risk profile and the risk-taking behavior of management.

On the stability of the capital base, there is a risk that capital will be impaired due to the possibility of further realized losses incurred from the sale of classified syndicated credits and corporate bonds, and the potential for further credit quality deterioration in the syndicated credit relationships listed for Special Mention. Syndicated credit losses totaling over $1 million have been realized over the 12-month period before the Joint Exam and have adversely affected both earnings and the capital base. These losses were due in part to the agreement with the State (as a condition of the State charter) that the Bank would maintain adversely classified assets at less than 35% of Tier 1 and Tier 2 capital, which necessitated the sale of classified assets (at a loss) to bring the ratio in line with the requirement.

Adversely classified loans represent 30% of total capital, and when combined with the syndicated credit relationships listed for Special Mention,[5] the total represents an

[5] According to the Risk Management Manual of Examination Policies, a "Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential
(Footnote continued on the following page)

excessive 118% of the Bank's total risk-based capital. Thus, despite the high capital ratios, deficient earnings, when considered with the volatility of the syndicated loan portfolio, threaten the capital base.

Presenting a significant risk to the capital base are the Bank's plans for growth. The Bank's proposed Business Plan included the purchase of some $25 million in syndicated loans, $1.9 million in corporate bonds, and $15 million in brokered deposits. During late 2008 and the early 2009, capital markets were in crisis and the syndicated credit and corporate bond markets experienced significant market price declines. Accordingly, the possibility of further impairment is real – there is an obvious potential of realized losses incurred from the sale of these syndicated credits, as well as further credit quality deterioration in the syndicated loan portfolio already listed for Special Mention.

Additionally, the 2008 capital injection of $** million accounts for the increased level of capital reported during this period. According to the Bank's CEO, no additional capital infusions are planned, a fact underscoring the significance of maintaining the capital base.

Finally, the Bank's risk profile has increased appreciably since the prior examination. Thus, although quantitative measures of capital may be high, historic FDIC material loss reviews reveal the importance of viewing capital as a lagging indicator. A decline below regulatory and statutory requirements may occur only after significant financial deterioration has taken place, at which point, recapitalization is increasingly difficult. Examiners are specifically directed to view the adequacy of capital in light of risks that may not have resulted in losses to earnings and capital. In this case, DSC asserts, these risks include a significant increase in criticized loans, material operating and market losses, plans for rapid growth, and an unproven management team and Business Plan.

The Committee's Findings. The Committee finds unpersuasive the Bank's capital argument. Of primary significance, the ratios presented in the chart offered in support of the Bank's argument are founded on comparison to peer performance and ***not*** on the Bank's own risk profile. A review of the case file reveals:

(Footnote continued from the previous page)
weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. . . . Careful identification of loans which properly belong in this category is important in determining the extent of risk in the loan portfolio and providing constructive criticism for bank management."

- The Bank showed a significant increase in criticized assets, from less than 5% at the 2008 examination to more than 100% at the Joint Exam;
- Criticized assets were concentrated in highly leveraged syndicated credits bought in late 2008. At the time of purchase, these loans were some 178% of total risk-based capital;
- The Bank experienced losses on the sale of criticized syndicated loans and corporate bonds of approximately $1.2 million in less than a year;
- Earnings were deficient, as reflected in operating losses in 2008, and through June 30, 2009.

The Bank's appeal presents no information to alleviate these very real concerns over the volume of criticized loans. The Bank's argument that its capital numbers exceed regulatory requirements is unpersuasive in the face of its high-risk strategy and its inability to control the risks to which the Bank is subject because of that strategy. Moreover, under the FFIEC Rating System, a "3" rating is ***specifically*** authorized even if the institution's capital level exceeds minimum regulatory and statutory requirements. Despite the high capital ratios, marginal earnings, coupled with concerns regarding the syndicated loan portfolio, pose a definite threat to the capital base.

The Committee also finds persuasive DSC's argument that capital is typically a lagging indicator – a decline below regulatory and statutory requirements may occur only after significant financial deterioration has taken place. Based on the Bank's risk profile (heavily concentrated in risky assets), its inability to control those risks as evidenced by the increase in criticized assets, the heavy losses on syndicated credits, and the deficient earnings, we find the Capital Adequacy rating of "3" appropriate.

2. Asset Quality.

Asset Quality is one of the most critical areas in determining the overall health of an institution. The Asset Quality rating reflects, in part, the quantity of existing and potential credit risk associated with the loan and investment portfolios. Asset Quality is rated based on a number of factors, including the adequacy of underwriting standards; soundness of credit administration practices; appropriateness of risk identification practices; the level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions; the adequacy of the ALLL and other asset-valuation reserves; the ability of management to properly administer its assets, including the timely identification and collection of problem assets; and the adequacy of loan and investment policies, procedures, and practices.

A ***Rating of 1*** indicates strong Asset Quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset Quality in such institutions is of minimal supervisory concern.

A ***Rating of 2*** indicates satisfactory quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management abilities.

A ***Rating of 3*** is assigned when the Asset Quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in Asset Quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk-management practices.

The Bank's Position. The Bank argues that information from the September 30, 2009 Call Report and the September 30, 2009 UBPR Report should have been considered, as that information constitutes facts and circumstances that existed prior to or at the time the material supervisory determination was made. That information included not only the capital ratios considered above but the following facts:

- classified assets were $*,***,*** and its capital was $**,***,***, for a classified assets coverage ratio of **.**% (a ratio significantly lower than the peer group);
- the SNC portfolio would have shown a gain of $1.1 million as of September 9, 2009 (in June, DSC examiners based their Asset Quality rating concerns on their belief that the portfolio ratings would be downgraded – in fact, they were not); and
- as of January 19, 2010, the Bank would have realized a gain of $*.* million rather than an actual loss of $*.* million.

Finally, the Bank challenges the rating as arbitrary, implying that because the SNC portfolio was not downgraded in August, DSC, in its September Joint Exam added Special Mention assets to their Asset Quality assessment to bolster that assessment, a calculation ***not*** performed for the June Visitation. Nor did the examiners analyze and credit, in the Bank's Asset Quality rating, the obvious market and financial improvements in the portfolio since the March 2009 rating determination date for the SNC 2009 annual review.

DSC's Position. DSC argues that the ROE demonstrates that the Bank's asset quality has deteriorated since the last full-scope Exam (the August 2008 Exam). This deterioration was evident at the June 15, 2009 Visitation as well and resulted in the Bank being assigned a "3" Composite rating based on the increase in the number of adversely

classified and criticized assets – mostly the syndicated loan portfolio. For the September Joint Exam, the Adversely Classified Items Coverage ratio has increased to 30% from 5% in the full-scope 2008 Examination. Of particular concern are eight syndicated loan relationships totaling $10,032,000 listed for Special Mention. Many of the loans within this group are rated by Standard & Poor's ("S&P") as BB- to B-. Many of those report:

- declining sales revenue;
- companies unable to meet management's financial projections;
- borrowers with high leverage positions;
- minimal cash-flow; and
- recession-related declining industry trends.

The Joint Exam lists syndicated loans classified as Substandard and listed for Special Mention at more than 100% of the Bank's Tier 1 capital and reserves. Syndicated loans identified as Special Mention in the September Joint Exam were also identified as Special Mention in the most recent Shared National Credit review (*see* fn 2). The Bank also has increased its exposure to corporate debt in the lower investment-grade bands. A part of such a portfolio would normally be subject to ratings changes, including downgrades, which would result in a decline in the quality of bond holdings.

Moreover, the June 15, 2009 Visitation identified the Bank's Syndicated Loan Policy as inadequate. It failed to establish thresholds or limits related to investments in syndicated loans, or concentration limits. The only limitation in the Policy was the pledge to maintain classifications under the **% of Tier I and Tier II capital that was a condition of the State's approval of the Bank's Business Plan and its savings bank charter. The Syndicated Loan Policy has not been amended and remains deficient. Also of particular concern, and as noted in the ROE, is the fact that no Bank officers are familiar with the syndicated credits. Director ***, who is a member of the Loan Committee, was engaged, through an outside consulting group, to perform quarterly reviews of the syndicated loan portfolio. Much of the data and information used to perform the review, however, is supplied by Mr. X's hedge fund and investment firm, XYZ.

Finally, the Bank sold selected syndicated loans and bonds, incurring substantial losses over the past year in excess of $1.5 million. Accordingly and significantly, the losses were the result of the confluence of three factors: (1) the agreement with the State, as a condition of its grant of the Bank's charter, that the Bank maintain the limited maximum classified asset ratio; (2) the volatility of the assets themselves; and (3) either the inability or the refusal on the part of the Bank to take cognizance of the interplay of those factors in establishing and carrying out rational and prudent loan and investment policies.

The Committee's Findings. Under a "3" FFIEC rating, trends may indicate deterioration in asset quality or an increase in risk exposure. The record of this case amply demonstrates both. The increase of the Adversely Classified Items Coverage ratio (from 5% to 30%) is indicative, as is the weakness of the syndicated loan portfolio:

- The Bank bought approximately $32 million face value ($25 million book value) of distressed syndicated credits in September and October 2008 without acceptable limits in relation to capital;
- These syndicated loans were purchased during a period of extreme market volatility;
- At the time of purchase, 60% of the syndicated loans had been listed as Special Mention or Adversely Classified at the then-current 2008 Shared National Credit review;
- The 2008 Shared National Credit review noted a high volume of syndicated loans with structurally weak underwriting, especially in the non-investment grade or leveraged transactions (the type of credit the Bank purchased). This information was publically available in an October 2008 press release by the bank regulatory agencies.[6]

In an attempt to comply with the State's mandate that adversely classified assets be maintained at or below **% of total capital, management initiated the sale of selected syndicated loans and bonds. Losses incurred during the fourth quarter of 2008, through June 30, 2009, totaled $1.2 million. While the Bank asserts that these losses were incurred as a result of its compliance with the State's mandate, that mandate was properly imposed and agreed to by the Bank. The losses were a direct result of the volatility of the assets, of which the Bank had appropriate notice. Thus, it was the syndicated loan portfolio and corporate bond purchases that were the cause of the loss, along with inadequate policies governing these purchases.

The Committee finds that this record is clear that the increase in adversely classified assets was initiated following the institution's change in Business Plan after Mr. X liquidated the bank holding company in September of 2008. The Bank immediately embarked on a plan to grow the institution (to over $1 billion in assets in at least one scenario) centered in syndicated loans, to be funded by brokered deposits. That change in the Bank's business model was followed, in close succession, by four related actions:

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[6] Joint Press Release, Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency, and Office of Thrift Supervision, "Shared National Credits Program Reports Large Increase in Credit Volume and Significant Deterioration in Credit Quality" (October 8, 2008).

1. The insistence on the part of the FRB on a full and substantive review of the Bank's proposed Plan;
2. The Bank's application to the State for a state savings bank charter;
3. The State's grant of that charter ***but*** conditioned on specific capital and ALLL restrictions clearly designed to mitigate the effect of the aggressive Business Plan; and
4. The Bank's notification of the FRB that the Bank intended to liquidate its holding company and expedite the execution of the proposed Plan.

It is entirely reasonable for this Committee to determine that that chain of events was a direct result of the significant changes in the Bank's Business Plan. Further, any time such a major action as a change-of-control is approved by a regulator, that approval is premised on the understanding and the obligation that the institution's business plan be executed as originally presented to the regulator. Additionally, and significantly for this Committee, the aggressiveness of the Bank's Plan, coupled with the above-listed actions of the other regulators stand as further and corroborative evidence of the justification for DSC's own doubts, as expressed to the Bank in DSC's May 16, 2008 letter (emphasis in original):

> We must reiterate our concerns with the Plan, as discussed with President *** and Majority Owner *** at a meeting held in the Regional Office on ****. The Plan continues to be premised on <u>substantial</u>, rapid asset growth funded primarily by borrowings and wholesale (brokered) deposits. Management expertise is unproven in managing risks associated with this strategy in a regulated banking environment, and adequacy of the proposed capital structure is questionable given the perceived increased risk profile of the bank. We encourage caution in your consideration of the proposed Plan.

On the basis of these facts, the Committee upholds the "3" Asset Quality rating.

Although syndicated loan purchases ended in 2008, in September and October 2009, the Bank increased its exposure to corporate debt rated BBB (the lowest investment-grade band, according to S&P definitions). We consider those purchases in the context of the supervisory determinations made with respect to the December Restrictions.

3. Management.

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to

ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in the Management rating. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. The Management rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

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 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.

A ***Rating of 3*** indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

The Bank's Position. The Bank disputes the downgrade of the Management component from a "2" to a "3" as inaccurately depicting the ability and results of the Bank's management team. Contending that it has added capacity and capability to the existing team, the Bank cites the experience of (1) Mr. ***, a highly qualified CEO with over 30 years of community banking experience; (2) Ms. ***, a seasoned banker bringing regional bank management skills to bear; and (3) Mr. ***, a CFO with strong financial management skills.

The Bank notes that management continues to implement the recommendations it receives from the FDIC, including revising the Business Plan to reflect a more traditional community bank plan. The Bank asserts that the Regional Office "has provided no explanation on why it believes that this management team is not capable of implementing the Bank's business plan, or is otherwise unqualified to conduct the Bank's business."

DSC's Position. DSC argues that, since the last examination, there have been significant board and management changes. There have also been substantial changes in the (still as-yet-unapproved) Business Plan. The former president, the senior vice president, and a director have all resigned. The principal shareholder, Mr. X, who made a $** million capital contribution in **** and was elected Chief Investment Officer in April of that year, is neither a director nor an executive officer, does not vote on the

board, and does not receive compensation. He is, however, considered a dominant figure and policy maker and recommends investments to the board. Mr. X and Director *** are the sole individuals knowledgeable about the Bank's syndicated loan portfolio. DSC acknowledges that the hiring of CEO ***, who has extensive community banking experience in the *** market, is a positive move. Ms. *** and Mr. *** were hired after the close of the Joint Exam.

The Management rating, however, is directly dependent upon the current condition of the Bank, as well as on its prospects. The increase in criticized and adversely classified loans is a product of the board-approved change in the Bank's risk profile during late 2008 and its continuing acquiescence since. The purchase of $25 million in syndicated loans and nearly $2 million in corporate bonds has led to substantial losses over the past year. Although the board has committed to no further purchases of syndicated loans, the credit and market risks associated with these credit relationships remain on the Bank's balance sheet. Syndicated credit relationships comprise nearly 70 percent of the Bank's loan portfolio, and a majority of these loans were either adversely classified or were listed for Special Mention at the time of the Joint Exam.

Finally, the Bank's board approved and purchased four investment-grade ("IG") corporate bonds totaling $5.7 million during the Joint Exam and the examiners were not informed. CEO *** contended that the bond purchases were exercised under the Bank's earlier Business Plan, although that Plan had not been approved by the regulators. The bonds were bought at a premium and have independent ratings of BBB. The October 20, 2009 joint letter followed, directing the board to submit additional information on its Business Plan and halt any further Business Plan changes or corporate bond purchases.

The Committee's Findings. As the Committee has already determined, the increase in criticized and classified loans is a direct outcome of the Business Plan approved and instituted by the board. Thus, the Bank's owner and board members are responsible for the high-risk strategy that caused the losses and are a direct outgrowth of imprudent concentration in highly leveraged, distressed syndicated assets. Further, the Business Plan was executed apparently with little concern for the deep doubts expressed by the Regional Office in its May 16, 2008 letter.

Moreover, although Mr. X does not vote on the board, he and Director *** are the sole individuals knowledgeable about the Bank's syndicated loan portfolio. Even so, discussions at the June 16 deliberative meeting revealed that the investment policy and decisions to carry out that policy were essentially in the hands of Principal Shareholder X.

Given the loan and investment decisions that were made without prudent policies and procedures in place, and given the fact that those decisions resulted in substantial losses to the Bank, the "3" Management rating is well justified.

4. Earnings.

The essential purpose of bank earnings, both current and accumulated, is to absorb losses and augment capital. Earnings are the initial safeguard against the risks of engaging in the banking business, and represent the first line of defense against capital depletion. The analysis of earnings includes all bank operations and activities. In evaluating the adequacy of a financial institution's earnings performance, the FFIEC Rating System gives consideration to the level, trends, and stability of earnings; the ability to provide for adequate capital through retained earnings; the quality and sources of earnings; and the level of expenses in relation to operations. The quality and quantity of an institution's earnings are adversely affected by inadequately managed credit risk or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. Finally, the Rating System measures the adequacy of provisions to maintain the ALLL and other valuation allowance accounts.

Earnings ***Rated 3*** may need to improve. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

A ***Rating of 4*** indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

The Bank's Position. The Bank challenges the downgrade in its Earnings component from a "3" to a "4" as unsustainable. The Bank points to its return on assets ("ROA") for September 30, 2009, which, at *.**%, puts the Bank in the **th percentile on that measurement in comparison to peer. The unsustainability of the rating is further corroborated, asserts the Bank, when the downgrade is viewed in the context of the December 31, 2009 Call Report showing a $***,*** profit, the $**,*** profit reflected in the September 30, 2009 Call Report, and the fact that the Bank's peer group reported negative income for that period in the September 30, 2009 UBPR Report.

DSC's Position. Questioning the significance of the Bank's ROA calculation of *.**%, DSC stresses that it is derived by annualizing only third-quarter results rather than year-to-date performance as figured in the UBPR Reports. Not only did the Bank select the best figure for the last two years, the figure, as a one-time, isolated view, shows neither consistency nor sustainability. Moreover, for the period at issue, through June 30, 2009, the Bank reported a net loss of $***,*** for a ***negative*** ROA of 0.**%.

DSC also highlights the negative effect of the syndicated credits, arguing that gross loan charge-offs of $***,*** were reported through June 30, 2009, of which

$***,*** were incurred on the sale of credits from the syndicated portfolio. During 2008, the Bank suffered gross loan charge-offs of $***,***, of which $***,*** were tied to the sale of syndicated credits. The Joint Exam identified $368,000 in loan losses tied to three syndicated credits and a small number of conventional loans. Given the level of loans classified by the September 2009 Joint Exam, as evidenced by the adversely classified loans to total loans of **.**%, DSC argues that earnings performance may continue to be adversely affected in future reporting periods, as long as syndicated credit quality issues and market pricing volatility persist.

The Committee's Findings. The Bank's earnings are decisively deficient – erratic, and with significant negative trends. In its effort to increase earnings, Management took excessive risk and generated losses that are well documented in this opinion and in the ROE. The Bank has:

- Net losses of $***,*** for a negative ROA of 0.**% through June 30, 2009, and $***,*** for a negative ROA of *.** through December 31, 2008;
- Provision expenses of $***,*** through June 30, 2009, and $*, ***,*** through December 31, 2008;
- Reported gross loan charge-offs of $***,***, including $***,*** in losses incurred on the sale of syndicated credits through June 30, 2009, and $***,***, including $***,*** in losses incurred on the sale of syndicated credits through December 31, 2008; and
- $***,*** in loan losses tied to three syndicated credits and a small number of conventional loans through June 30, 2009.

The Committee affirms the Earnings rating of "4" on the basis of these figures.

5. Composite Rating.

Composite ratings are based on an evaluation of an institution's managerial, operational, financial, and compliance performance, through an assessment of the six key components of an institution's financial conditions and operations – its **CAMELS** rating: **C**apital Adequacy; **A**sset Quality; **M**anagement's Capability; **E**arnings Quantity and Quality; Adequacy of **L**iquidity; and **S**ensitivity to Risk. But although the composite rating generally bears a close relationship to the component ratings, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. Some components may be given more weight than others, depending on the situation at an institution. Assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the institution.

A ***Rating of 2*** is an indication that an institution is fundamentally sound. Under the FFIEC standards, an institution with a Composite rating of "2" presents only moderate weaknesses – weaknesses that are well within the Board's and management's capabilities and willingness to correct. The rating is indicative of an institution that is both stable and capable of withstanding business fluctuations. Such an institution is in substantial compliance with all laws and regulations, and overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. Because there are no material supervisory concerns, the supervisory response is informal and limited.

An institution with a ***Rating of 3*** generates some degree of supervisory concern in one or more of the component areas. The combination of weaknesses may range from moderate to severe, though the magnitude of deficiencies is not as great as an institution with a Composite rating of "4." Management may be unable or unwilling to address weaknesses effectively and efficiently. A "3" institution is less capable of withstanding business fluctuations and is more vulnerable to outside influences than those institutions rated a Composite "1" or "2." Risk management practices are not satisfactory relative to the institution's size, complexity, and risk profile. A "3" institution requires increased supervision, which may include formal or informal enforcement action. Failure appears unlikely, given the overall strength and financial capacity of the institution.

The Bank's Position. The Bank maintains that the material supervisory determinations fail to accurately reflect the true financial condition of the Bank, reasoning that its strong numbers belie its "3" Composite rating:

- its classified assets coverage ratio is low in comparison to peer;
- its ALLL is conservatively funded and regulatory-compliant;
- it has hired a highly qualified CEO;
- some $5 million in brokered deposits have run off; and
- as of June 30, 2009, its Tier 1 leverage capital ratio was **.**%, its Tier 1 risk-based capital ratio was **.**%, and its total risk-based capital ratio was **.**%.

The Bank goes on to stress that its performance, as illustrated in the September 30, 2009 UBPR Report, exceeded and continues to exceed peer performance in virtually every operational area, most notably, capital, and that, as of September 30, the Bank was better capitalized than **% of its peers. Although DSC had in its possession facts justifying upgrades in both the component and composite ratings, the Bank asserts that the Regional Office refused to consider that favorable information.

DSC's Position. The Division maintains that the Bank's condition gives ample cause for supervisory concern in light of the decline in asset quality, inadequate risk management and board oversight, and weak earnings performance. The Bank's Composite rating was initially downgraded from a "2" to a "3" as a result of the June 15,

2009 Joint Visitation. The Bank's departure from its original business plan in favor of a high-risk strategy funded by insured deposits poses a risk to the insurance fund and warrants heightened supervision until the new management team returns the Bank to satisfactory condition and successfully executes a more prudent business plan. DSC points out that the volume of criticized loans, primarily evidenced in the syndicated loan portfolio, has increased significantly since the 2008 full-scope exam in August and, in fact, exceeds total capital. Earnings performance is poor with continued loan losses.

The Committee's Findings. The Committee has carefully reviewed the examination and the entire record of this case. To the Committee, the Bank presents a well-supported case for a Composite "3" rating. The Bank, during the period at issue, experienced serious deficiencies, particularly in Capital, Asset Quality, Management, and Earnings. The Bank has proven less capable of withstanding business fluctuations and more vulnerable to market influences than higher-rated institutions. This vulnerability was on clear display in the significant losses taken in a highly volatile market – a market in which the Bank elected to trade.

The decline in asset quality, weak earnings, and persistent operating losses were the result of a business model that favored a high-risk strategy funded by insured deposits. That business model, severely criticized by the FRB and the FDIC, was the creation of management and Principal Shareholder X. In sum, the Committee determines that the Bank is appropriately rated a Composite "3" on the basis of an ill-advised business plan that adversely affected the institution's condition and resulted in downgrades in its CAMELS ratings.

B. The Growth Limit Supervisory Determinations.

1. December 17, 2009 Letter Limiting Balance-Sheet Growth.

Under the Regional Office's December 17, 2009 letter, the Bank is required to obtain a non-objection from the Regional Office before engaging in any transactions that would materially change the balance sheet composition, including growth in total assets of 5% or more, or significant changes in funding sources, such as increasing brokered deposits or volatile funding.

The Bank's Position. The Bank argues that the growth restriction imposed on it is based solely on the "3" composite rating, despite the volume of information it provided to DSC:

Thus, in addition to the September 30, 2009 Call Report and the UBPR Report, which the Bank alleges stand as corroborative evidence of the Bank's robust financial health, when The Regional Office imposed the December 17 Restriction on the Bank, DSC had been provided with detailed information in support of its investment policy, pursuant to the Bank CEO's November 3, 2009 letter, which included the:

- pre-purchase analysis procedure for corporate IG bond purchases;
- Investment Policy and its objectives;
- board responsibilities with respect to the Investment Policy;
- investment reporting and recordkeeping responsibilities;
- dealer screening procedures;
- investment approval process;
- description of contents of investment portfolio;
- investments rules and limitations;
- liquidity levels;
- Contingency Liquidity Plan; and
- Investment Strategy.

DSC's Position. DSC responds that the Regional Office simply followed established FDIC policy in imposing the December 17 letter limiting balance-sheet growth. Under Regional Director Memorandum 2009-42 ("RD Memo"),[7] a financial institution newly rated a composite "3," "4'" or "5" is expected to limit balance-sheet growth and take actions to strengthen its risk profile as it works to remedy its problems. According to DSC, the policy is specifically applicable to the Bank:

> Supervisory concern is elevated when ***any*** institution is, or may become, reliant on brokered or higher-cost Internet deposits, secured borrowings, . . . or other potentially volatile wholesale funding sources. However, financial institutions newly rated composite "3," "4," or "5" that engage in material growth strategies or significantly shift balance sheet compositions warrant heightened supervisory oversight and enforcement action.

RD Memo at p. 1 (emphasis in original).

Thus, DSC argues, the RD Memo (as illustrated by a sample Examination Letter) requires the non-objection language to be included in a letter to the Bank's management at the close of an examination in which the Bank is newly rated "3," "4," or "5." The language in the letter may be tailored to reflect individual circumstances, but its purpose – to control new risks the Bank may take – is expected to remain intact. This guidance was made publicly available to all insured depository institutions in Financial Institution Letter 13-2009, *The Use of Volatile or Special Funding Sources by Financial Institutions that are in a Weakened Condition*.

The Committee's Findings. The Committee finds that the restriction limiting balance-sheet growth was properly imposed and according to established and published

[7] RD Memo 2009-42, "Issuing Examination Letters to Troubled Institutions."

FDIC policy. Indeed, under the policy the Bank is required to administer the institution in such a way as to stabilize the risk profile and strengthen the financial condition:

> Actions taken by a troubled financial institution to materially expand the balance sheet or risk profile are inconsistent with this expectation. Therefore, your Bank is required to obtain a non-objection from the Regional Director before engaging in any transactions that would materially change the balance sheet composition, including growth in total assets of five percent or more or significant changes in funding sources, such as by increasing brokered deposits or volatile funding. These are interim requirements until the Report of Examination and any corrective program are finalized.

RD Memo at p. 1.

Such a restriction, tailored to reflect individual circumstances, is routinely levied on institutions with a newly rated Composite figure of "3," as is the case with the Bank. The policy is specifically fashioned to respond to institutions, such as the Bank, that engage in material growth strategies funded by higher cost or volatile funding sources. The Bank's growth in 2008 was **%, and **% in 2009 and the volatility of its funding sources have been well documented in this opinion. The limits applied are interim measures until corrective action has taken place, and we affirm the imposition of the limits as fully congruent with FDIC policy, reasonable, and balanced.

2. December 23, 2009 Letter Prohibiting the Purchase of Corporate Bonds.

Under the December 23, 2009 letter, jointly from the FDIC Assistant Regional Director and the state regulator, the Bank is instructed to cease purchasing any further corporate bonds and notified of a targeted visitation focusing on the corporate bond portfolio and the proposed change in Business Plan. The letter expressly cites the Bank's "increased risk profile." In affirming the Regional Office in its imposition of the Restriction, the Director found that the order was justified in restricting such investments until prudent limits [were] established in relation to Tier 1 capital.

The Bank's Position. The Bank argues that when, in February 2008, it informed the FRB, the State, and the FDIC of the proposed changes in its Business Plan to grow the institution from $** million in total assets to over $* billion, the State approved the Plan and the FDIC did not object. Nevertheless, in implementing the Plan, when the Bank purchased $25 million in syndicated loans and issued $15 million in brokered deposits in October 2008 to fund the purchase, the Regional Office suddenly ***did*** object, despite its earlier, according to the Bank, acquiescence. Thus, The Regional Office

demanded that the Bank immediately cease all purchases of syndicated loans and brokered deposits.

Although the Bank offered several times to meet with the Regional Office, and offered infusion of "a huge amount of Tier 1 capital to support its activities," the Regional Office refused to meet, "changed its mind, and suddenly did not approve the Bank's business model." However, the Bank adjusted its Plan to that of a "completely traditional community bank," recommitting to The Regional Office that it would refrain from syndicated loan purchases and from increasing its brokered deposits. The Bank has reduced the size of its syndicated loan portfolio by 22% and its brokered deposits by 33%.

In an effort to avoid the erosion of its capital, and, the Bank asserts, to make use of significant excess cash derived from its successful campaign to increase "core deposits," in September and October of 2009, the Bank invested nearly $8 million in IG bonds. "These purchases," contends the Bank, "inexplicably deeply angered the Regional Office," which demanded that the Bank cease purchasing IG bonds. The November 3, 2009 letter followed, in which the Bank argued that the failure to invest the cash would result in losses that would erode the Bank's capital, and the Bank reasonably believed the failure to deploy the cash by the purchase of IG bonds would result in an unsafe and unsound condition.

The November 3 letter also provided the Regional Office with the Bank's newly revised Investment Policy, reflecting revisions made in response to comments made by the Assistant Regional Director in the October 16, 2009 Exit Meeting for the September Joint Exam. As a part of that Investment policy, the letter explained:

> [We will] continue to purchase IG bonds until we have acquired the necessary personnel to properly expand our loan origination capabilities. We believe we have sufficiently modified our Investment Policy in accordance with your expressed concerns for limitations on investment-grade purchases based on ratings and percent of capital.

Accordingly, the Bank asserts that the information provided in the Investment Policy undercuts the Director's affirmance of the Regional Office restriction on the purchase of corporate bonds. Prudent limits had already been established as part of the revised Investment Policy, well in advance of the December 23, 2009 restriction on bond purchases.

DSC's Position. DSC acknowledges that a prohibition against the purchase of corporate bonds is unusual but emphasizes that the Bank's board had approved the purchase of lower investment-grade bonds to an excessive degree. During September and October 2009, the Bank had purchased nearly $8 million in corporate bonds that

were rated BBB, the lowest investment grade, amounting to approximately 66% of the Bank's Tier 1 capital. These securities may be subject to ratings changes, including downgrades that would result in sub-investment quality holdings.

Further, the bond investments, DSC adds, were made without board-established limits for the lower investment grade bands or the corporate bond portfolio as a whole, in relation to capital. This was also the case with the syndicated loan portfolio.

The Bank's revised Investment Policy (submitted with the November 3, 2009 letter) placed limits for the lowest investment-grade band at 200% of capital, and 400% of capital for the corporate bond portfolio as a whole. DSC stresses that the Bank already had some 130% of total capital invested in syndicated credits, most of which were criticized or classified. DSC believes that these limits are unacceptably high.

The Committee's Findings. The Committee finds the prohibition well justified. The purchase of the bonds was made without ***any*** board-established limits. The Committee further finds the limits that finally were imposed by the Bank's revised Investment Policy – of 200% of capital and 400% of capital for the corporate bond portfolio as a whole – unreasonably excessive. Because the Bank had continued engaging in higher risk activity without prudent risk management procedures and controls in place, the Committee determines that the Regional Office was justified in halting the activity until acceptable investment policies could be established.

In Conclusion. The Committee finds the record of this case a disturbing one, marked, as it seems to be, by an apparent disregard for the supervisory process. After obtaining the state savings bank charter, it proceeded with its aggressive Business Plan despite the concerns of both FRB and FDIC. In its appeal papers, the Bank asserts that the State approved of its Business Plan and the FDIC did not object. In fact, the State approved the Plan contingent on three significant conditions intended to control risk. Moreover, the FDIC's May 16, 2008 letter expressed distinct, strong concerns with the Plan, among other things, that it was premised on substantial rapid growth funded primarily by borrowings and brokered deposits. Additionally, that letter specifically referenced the **** meeting with the Bank president and Mr. X at which time DSC personnel went over in some detail their difficulties with the Plan, the adequacy of the proposed capital structure, and the risk profile of the Bank.

In October 2008, the FDIC sought and received the Bank's commitment to halt growth. In December, the Principal Shareholder committed to stop additional purchases of syndicated loans and brokered deposits. Regardless, the Bank continued making purchases of potentially volatile assets, without any prior notice to the regulators. In October 2009, the Bank was told to cease its purchase of corporate bonds, an order it refused to comply with in November. During the period at issue in this proceeding, the Bank declined to agree to sign two MOUs.

The Bank's claims that the Regional Office reversed its opinion regarding the Bank's Business Plan and that its September and October 2009 purchases of corporate bonds "inexplicably angered" the Regional Office are not credible viewed in the light of these facts. The Bank's protest in its November 3 letter that it was not submitting a request to change its Business Plan but merely modifying the Plan to reflect growth or respond to DSC revisions also lacks merit. The Bank's 2009 purchases constituted a refusal to comply with a regulatory direction that had been based on rational supervisory concerns that purchasing additional higher-risk assets, especially in view of the significant losses the Bank had already suffered, would not improve the Bank's balance sheet.

The Committee acknowledges that the Bank has taken positive steps more recently in an attempt to adopt a more prudent business strategy, to reduce exposure in brokered deposits and syndicated loans. We are also encouraged by the hiring of experienced senior managers, who, we hope, will return the Bank to satisfactory condition and operate the Bank within accepted risk tolerances.

IV. Conclusion.

For the foregoing reasons, the Bank's appeal is denied as set forth in this opinion. This decision is considered a final supervisory decision by the FDIC.

By direction of the Supervision Appeals Review Committee of the FDIC, dated August 17, 2010.

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Thomas E. Nixon
Counsel, Executive Secretary Section
Legal Division