

**Decision of the
Supervision Appeals Review Committee**

In the Matter of * * *

Case No. 2024-05

I. Summary

By letter dated July 22, 2024, * * * (Bank) submitted an appeal to the Supervision Appeals Review Committee (Committee) seeking review of several ratings assigned by the FDIC as a result of the Bank's September 6, 2022 safety and soundness examination. In the appeal, the Bank also sought removal of its "troubled condition" status. As described below and based upon review of the evidence submitted at the time of the examination and in connection with the appeal, the Committee finds in favor of RMS with respect to the Capital and Earnings component ratings and the Bank's "troubled condition" status, and finds in favor of the Bank with respect to the Asset Quality and Liquidity component ratings and the composite rating.

II. Background and Procedural History

In * * *, a group of investors acquired the Bank's holding company and recapitalized the Bank. The investors' business plan involved pursuit of a strategy that relied substantially on third-party arrangements. The business plan also maintained the Bank's longstanding business of providing traditional banking services to customers located within the Bank's core geographic footprint of * * *.

The FDIC and the [State] commenced a safety and soundness examination of the Bank on September 6, 2022. After the on-site portion of the examination concluded, the FDIC and the State expanded the scope of the examination. The second phase of the examination commenced in May 2023 and resulted in supervisory findings regarding third-party risk management, anti-money laundering/countering the financing of terrorism (AML/CFT) compliance, credit administration, funds management practices, and the Bank's information technology (IT) program.

On August 1, 2023, the FDIC sent the Bank a letter stating that based on preliminary examination findings, potential deficiencies in the Bank's third-party programs presented safety and soundness concerns, and as a result, the FDIC was requesting that management * * *.

On March 7, 2024, the FDIC issued its report of examination (ROE), assigning the Bank CAMELS ratings of 334443/4. At the same time, the FDIC notified the Bank that it was deemed

to be in “troubled condition” pursuant to 12 CFR § 303.101(c). The State issued a separate ROE, assigning CAMELS ratings of 324433/3.

On May 6, 2024, the Bank submitted a request for review to the FDIC’s Director of the Division of Risk Management Supervision (RMS), appealing the Capital (“3”), Asset Quality (“3”), Earnings (“4”), and Liquidity (“4”) component ratings, its Composite rating (“4”), and its “troubled condition” designation.

On June 20, 2024, the Director of RMS upheld the assigned ratings and the “troubled condition” designation. The Bank subsequently appealed the Capital, Asset Quality, Earnings, and Liquidity component ratings, its Composite rating, and “troubled condition” status to the Committee on July 22, 2024.

In accordance with the *Guidelines for Appeals of Material Supervisory Determinations (Guidelines)*, the Committee has reviewed the appeal for consistency with the policies, practices, and mission of the FDIC, and the reasonableness and support for the positions of the parties. The Committee heard oral presentations from the parties on October 22, 2024 and subsequently met to consider the appeal.

The ROE used June 30, 2023 as the “Examination as of Date.” Under the Guidelines, the Committee was able to consider events that occurred up until the date of the ROE, which is March 7, 2024.

III. Discussion

Capital Rating

The Bank asserts that it is well-capitalized and capital “is rated primarily on quantitative metrics and comparisons of capital levels with risk.” The Bank also notes that the ROE acknowledged that the Bank’s capital policy was “generally appropriate.” In the Bank’s view, the “3” Capital rating was upheld by the Division Director based on cited deficiencies in the AML/CFT compliance framework, which “conflates the purposes of the Capital and Management ratings.” The Bank also argues that RMS’s concerns that AML/CFT compliance deficiencies may lead to termination of the [Third-Party 1] sweep program and lower capital levels are “speculative,” and notes that the present circumstances would not give rise to a termination event under the Bank’s contract with [Third-Party 1] and, in any event, [Third-Party 1] has provided no indication that termination of the sweep program is under consideration.

RMS argues that minimum capital ratios are acceptable for institutions that have no material or significant financial weaknesses but maintains that the Bank has an elevated and evolving risk profile. In particular, RMS points to agreements with multiple third parties that resulted in rapid deposit growth, serious apparent AML/CFT violations, and insufficient due diligence and risk management practices regarding [a lending program]. RMS also notes that actual and projected

growth increases the need for maintaining additional capital, particularly if the Bank's participation in the [Third-Party 1] sweep program were terminated.

Asset Quality Rating

The Bank argues that its level of classified items is low and its allowance for credit losses was adequate. While the Director's decision cited credit administration concerns relating to [a lending program], the Bank asserts that only * * * of this portfolio was classified at the time of the exam and the decision did not give sufficient weight to [certain support features] in place for this program, including * * *. In particular, the Bank points out that total charge-offs to date amounted to only * * *.

RMS argues that a "3" Asset Quality rating is appropriate and consistent with forward-looking supervision despite a low level of adversely classified items, as the rating also reflects valid concerns regarding the credit administration practices identified by examiners. RMS notes that [support for the program was weakened]. RMS also asserts that examiners identified necessary improvements to the Bank's investment policy for Collateralized Loan Obligations (CLOs), and Bank management had not updated procedures to reflect the implementation of the Current Expected Credit Losses (CECL) methodology.

Earnings Rating

In the Bank's view, the FDIC's Earnings rating of "4" reflects an evaluation of net interest margin (NIM) rather than other sources of earnings, such as non-interest income. The Bank argues that it has a sustained, positive earnings trajectory * * *, even while making substantial investments to enhance its risk and compliance infrastructure. The Bank asserts that its ability to reach sustained profitability should invalidate any concern that its business model is structurally unprofitable.

RMS contends that while the favorable trend is a consideration in rating the Bank's earnings performance, the Bank's "4" rating is appropriate in light of its [level of profit], uncertainty regarding earnings sustainability, and the Bank's need to increase overhead to establish risk management infrastructure, which will come at a substantial cost that will erode the Bank's earnings projections. RMS maintains that regulatory concern over low NIM is valid, as the Bank's cost of funds remains high due to reliance on rate-sensitive third-party deposits. RMS acknowledges that non-interest income is a significant aspect of the Bank's business model, but argues that the [program] has not yet produced sufficient revenues to offset expenses.

Liquidity Rating

The Bank highlights that it has liquidity of * * * million, comprising * * * of total assets, as well as off-balance sheet sources of liquidity that the State found "ample." The Bank believes that the "4" rating is based on concentration risk arising from its relationship with [Third Party 2], a

[firm] that [activity] on behalf of the Bank. The Bank acknowledges there is risk of [transition issues], but argues that it has mitigated these risks and there is “no realistic scenario” where the entire [Third Party 2] relationship could be lost overnight. The Bank also notes it has a * * * million portfolio of CLO securities that it could sell¹ in addition to Federal Home Loan Bank (FHLB) and Federal Reserve Bank funding sources should a liquidity need arise.

RMS argues that the Bank * * * requires higher levels of on-balance sheet liquidity and more formal funds management practices to support its complex business model. In RMS’s view, the Bank’s cash flow modeling does not provide sufficient detail or granularity to model third-party deposits or conduct sufficient stress testing. RMS argues that the CLOs held by the Bank do not have high trading volumes, reducing their effectiveness as a liquidity source, and a portion of the Bank’s debt securities is pledged to borrowing lines. RMS asserts that the Bank continued to operate outside of concentration policy limits at the time of the examination.

RMS also argues that the Bank has not established exit strategies for * * *. With respect to the [Third Party 2] relationship in particular, RMS asserts that exiting the relationship would deplete liquid assets to unacceptable levels.

Composite Rating

The Bank argues that it has high levels of capital and liquidity, few problem assets, and is well-capitalized, with * * * positive earnings growth. The Bank contends that it has withstood the changing interest rate environment as well as the market stress of March 2023, and has made substantial progress in diversifying its deposit base. The Bank also points out that its * * * memorandum of understanding (MOU) was terminated, and the State acknowledged substantial completion of its corrective actions before delivery of the 2022 ROE.

RMS argues that the Bank’s “4” Composite rating is based on a comprehensive evaluation of its managerial, operational, financial, and compliance performance, with significant weaknesses cited in all of these areas. At the time of the examination, the Bank’s board of directors and management had not addressed all provisions within the * * * MOU, including provisions relating to management, liquidity, strategic plan, and apparent violations of laws and regulations. RMS asserts that the Bank’s capital adequacy, asset quality, earnings performance, and liquidity have all been adversely impacted by management’s aggressive strategy to rapidly grow through third-party deposit gathering without first implementing appropriate risk management policies and practices. RMS maintains that it employs a forward-looking supervisory approach, and in addition to the Bank’s current financial condition, the Bank’s rating reflects its risk management practices given its business activities and risk profile.

Troubled Condition

¹ The Bank asserted that a senior CLO trader at its investment bank indicated that the Bank could liquidate its CLO portfolio on short notice if necessary. The Bank also noted it could pledge the CLOs to access credit from the Discount Window.

The Bank was deemed to be in “troubled condition” due to its “4” Composite rating. The Bank notes that * * *. Thus, in the event the Committee were to upgrade the Composite rating to “3” or higher, the Bank requests that its designation as in “troubled condition” status also should be removed.

IV. Committee Findings

The Committee has stated in the past that assigning supervisory ratings “inevitably involve a degree of subjectivity and judgment on the part of examiners.” A bank seeking the Committee’s review of a rating must present sufficient evidence to demonstrate that the rating assigned was not appropriately supported by the record or that its assignment is inconsistent with FDIC policy or practice. In this case, the Committee finds in favor of the Bank with respect to the Liquidity and Asset Quality component ratings, along with the composite rating. The Committee finds that the Bank did not provide sufficient evidence to overturn the Capital and Earnings ratings.

Regarding the Capital component rating, the Committee acknowledges the Bank’s arguments that the Bank is well-capitalized by regulatory metrics, capital levels were in line with the projections in the Bank’s strategic plan, and the Bank’s holding company has demonstrated the ability to support the Bank. However, the Committee finds that the Bank has not presented sufficient evidence to demonstrate that a Capital component rating of “3” is not appropriately supported by the record or is otherwise inconsistent with FDIC policy. As RMS noted, the Bank remains in the early stages of implementing its new business plan, which to date has involved * * *; the Bank’s strategic plan and budget reflect declining capital levels and the need for further capital injections; and while the Banks’ capital metrics are above its target levels, the Bank’s capital reporting does not provide forward-looking projections. In addition, the Bank’s earnings performance * * * did not support capital formation. Consequently, and combined with other considerations, the Bank did not provide sufficient evidence to demonstrate that current capital levels are sufficient to support the Bank’s risk profile.

Regarding the Asset Quality component rating, the Committee finds that asset quality is satisfactory. Most of the Bank’s assets are cash and cash equivalents and investment securities that have not demonstrated poor credit quality, and the Bank’s loans have generally experienced low levels of losses. The Bank’s investment securities are comprised of senior (AAA-rated) tranche positions in CLOs for which the underlying credit collateral is generally a mixture of Shared National Credit loans. Losses associated with the * * * lending program cited in the ROE were low. As of June 30, 2023, total adversely classified items equaled * * * million, or * * * percent of Tier 1 Capital plus ACL, with * * * lending contributing only * * *. While RMS identified weaknesses related to the Bank’s credit risk identification, mitigation, monitoring, and reporting of credit risk that should be addressed, the Committee finds that credit administration practices overall are not less than satisfactory. As a result, the Committee agrees with the Bank that a “2” would be consistent with the ratings standards and more appropriate than a “3.”

Regarding the Earnings component rating, the Committee acknowledges that: the Bank's lack of profitability was a result of its deliberate strategic choice to sacrifice profitability as it built its infrastructure; the Bank's earnings trajectory is positive; and the Bank's positive earnings in * * * call into question whether the Bank could be appropriately characterized as "structurally unprofitable," as RMS described the Bank in the ROE. Nonetheless, given that the Bank was losing money * * *, the Committee finds that the Bank has not presented sufficient evidence to demonstrate that an Earnings component rating of "4" is not appropriately supported by the record or is otherwise inconsistent with FDIC policy.

Regarding the Liquidity component rating, the Committee acknowledges RMS's views that the Bank's * * * warrants higher levels of liquidity, and that the Bank has risk management weaknesses that warrant remediation. However, the Committee finds that liquidity levels are not deficient and the Bank's funds management practices are not inadequate. The Bank holds substantial liquidity, including * * * million in cash, due from accounts, and federal funds sold; * * * million in borrowing capacity at an FHLB and Federal Reserve Bank; and * * * million in CLOs. Even excluding the CLOs, the bank still maintains sufficient liquid assets plus FHLB and Federal Reserve borrowing capacity to cover all the deposits associated with the [Third Party 2] relationship. While RMS identified weaknesses related to the Bank's risk management policies and processes for the nature and complexity presented by its third-party arrangements, the Committee does not view those weaknesses as resulting in inadequate overall funds management practices at the time of the examination. Accordingly, the Committee agrees with the Bank that a "3"² would be consistent with the ratings standards and more appropriate than a "4."³

Regarding the Composite rating, the Committee agrees with the Bank that a "3" would be consistent with the ratings standards and more appropriate than a "4." According to the FDIC's Examination Manual, a 3-rated bank "exhibits some degree of supervisory concern in one or more component areas," "exhibit[s] a combination of weaknesses that may range from moderate to severe," and "require[s] more than normal supervision, which may include formal or informal enforcement actions." The Manual also notes that "the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4" and "failure appears unlikely, however, given the overall strength and financial capacity." By contrast, 4-rated banks "generally exhibit unsafe and unsound practices or conditions," have "problems [that] range from severe to critically deficient," and "pose a risk to the deposit insurance fund." The Manual also notes that "failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved." In light of the above findings, the Committee finds the description of a composite "3" more closely resembles the Bank than that of a "4".

² According to the Examination Manual, "[a] rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices."

³ According to the Examination Manual, "[a] rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs."

Regarding the Bank's "troubled condition" status, * * *.

V. Conclusion

For the reasons stated above, the Committee finds in favor of RMS with respect to the Capital and Earnings component ratings and the Bank's "troubled condition" status, and finds in favor of the Bank with respect to the Asset Quality and Liquidity component ratings and the composite rating.