**Decision of the**
**Supervision Appeals Review Committee**

**<u>Case No. 2009-04</u>**

## *I. Summary of Findings.*

After consideration of the timely filed written submissions of the parties, the record of this case, and following the December 18, 2009 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 loan classifications and the Capital, Asset Quality, and Composite ratings are well-founded and supported by the Bank's record of risk management practices. Unfortunately, that record reveals a rising level and trend of the percentage of adversely classified assets; marked credit administration weaknesses; and significant loan-policy deficiencies. The Committee finds that the Division of Supervision and Consumer Protection has demonstrated that the adverse loan classifications designated in the August 8, 2008 Examination, as amended on July 21, 2009, as well as the composite and component ratings, as amended, are consistent with FDIC policy and existing examination guidance, and that the classifications and ratings are appropriate, given the facts available at the time of the Examination.

## *II. Background.*

### *A. Introduction.*

***, ***, *** ("***," or the "Bank") is a state-chartered, commercial bank with total assets of $**.* million, serving the *** metropolitan area. In a locale where there is strong competition from other financial institutions for both loans and deposits, the Bank has developed a business plan for certain market niches. The main office is located in a predominantly Latino community, and the Bank has the highest deposit share in that Latino community of any insured depository institution in the area. An additional focus for the Bank is providing banking products for seniors at both traditional branches and branches located within retirement centers. The Bank operates seven of these branches in senior living communities in *** and adjacent suburbs, and, here, too, provides the community with essential banking services.

The Bank has directed its efforts toward effectively serving these community needs. The Bank offers this small-dollar loan product to low- and moderate-income bank customers – the underserved market customers with limited or poor credit histories – with the objective of helping customers avoid reliance on high-cost debt.

This appeal arises from disputed material supervisory determinations set forth in the Risk Management Report of Examination ("ROE," or the "Exam") of the Bank, issued by the *** Regional Office (the "Regional Office") on August 8, 2008. The Exam

was conducted independently and resulted initially in CAMELS ratings of 243322/3.[1] On January 9, 2009, 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 contended in its Request that inappropriate classification of the loans in four customer relationships essentially caused a cascade of downward grades of its composite and component ratings: had the loans been properly graded as "Pass," the Bank urged, it would have merited a "2" rating for Asset Quality rather than the "4" it received; its Capital rating of "2" would have properly been a "1"; and it would have correctly earned a "2" Composite rating rather than the "3" that it was assigned.

Following the Bank's January 9, 2009 Request, the Regional Office conducted a secondary review of the ROE and on June 11, 2009, informed the Bank that it would recommend to the Director that the ROE be modified: (1) two of the loans at issue should be reclassified as "Pass," based on record evidence confirming that the loans were adequately supported by collateral or paid down before final processing of the ROE; (2) the Asset Quality rating should be upgraded to "3" as a result of the reclassification of the assets; and (3) the Capital rating of "2" and the Composite rating of "3" should stand as fully supported by the ROE findings. By letter of July 21, 2009, the Director affirmed the modifications recommended by the Regional Office. The CAMELS ratings, as amended, are 233322/3.

The Bank timely filed an appeal with the Supervision Appeals Review Committee (the "Committee") by letter dated August 18, 2009. The Bank contests the Substandard classification assigned to the loans from four customer relationships and appeals for an upgrade to "Pass" in each of these cases. Additionally, the Bank disputes its Asset Quality rating of "3," its Capital Adequacy rating of "2," and its Composite CAMELS rating of "3," requesting upgrades of one level in each of these categories.

### *B. A Summary of the Parties' Contentions.*

The Bank's principal argument in its appeal focuses on the Substandard classification for loans in four loan relationships, which the Bank asserts directly resulted in inappropriate downgrades to the Bank's Capital and Asset Quality components as well as its Composite rating. Claiming that the Substandard classifications are at odds with the specific requirements mandated by the FDIC's *Risk Management Manual of Examination Policies* (the "*Risk Management Manual*"), the Bank contends that its collateral positions are more than adequate and supported by valid appraisals and that the loans are backed by multiple sources of payment, including guaranties, pledged collateral, and income generated by secured property. Additionally, the Bank maintains that cultural differences offer an explanation for certain sporadic delinquencies and even

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

nonaccrual loans among some of the Bank's Latino borrowers. The Bank emphasizes that it is mindful of and sensitive to the nonconventional practice of incurring delinquencies because loan payments have come due during borrowers' absences to *** to visit family. In such instances, the Bank has accommodated borrowers, reasoning that their histories evince both the ability and the intention to pay, noting the difficulties in making cross-border payments, and observing that on their return to the United States, such borrowers would regularly and immediately bring all loans current. The Bank asserts that these explanations are fully documented in its files.

DSC disputes each of these claims and argues that the Substandard classifications are well supported and in harmony with the *Risk Management Manual* requirements. In response to the Bank's cultural argument, DSC focuses its substantiation of the ROE findings on what it cites as out-of-date appraisals, weak collateral positions, undocumented collateral, delinquent real estate taxes, inadequate cashflow to support payment, past-due loans, and a substantial decline in guarantor cash positions.

In accordance with the *Guidelines for Appeals of Material Supervisory Determinations* ("*Guidelines*"),[2] 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. When the Committee met to consider the matter on December 18, 2009, the Bank elected not to appear. The Committee has carefully considered the written submissions of the parties. Under the *Guidelines*, the burden of proof on all matters at issue rests with the institution. Further, the scope of the Committee's review is limited to the facts and circumstances existing at the time of the examination. No consideration has been given to facts or circumstances that developed after that period.

## *III. Analysis.*

### *A. Preliminary Procedural Matters.*

The Bank complains that it was not given sufficient time and opportunity to review the Exam before it was finalized. The Bank points out that, while the ROE was delivered to the Bank on November 18, 2008, by the time the Bank Board of Directors met with the Examiner in Charge (the "EIC") two days later, the Bank was told that the Exam was "written and received," and that the time for resolving all disputes had expired. This treatment, the Bank asserts, wholly undercuts any "good-faith effort" an institution is encouraged to engage in "to resolve any dispute concerning a material supervisory determination with the on-site examiner and/or the appropriate Regional Office." *Guidelines*, at Sect. E. The Bank also complains that DSC never responded to two memoranda sent to the FDIC following the Exit Meeting. Those memoranda, the Bank contends, specifically disputed certain loan classifications. The Bank further objects that, following its timely filing of its Request on January 9, 2009, and in contravention of

[2] The *Guidelines* are set out at 73 Fed. Reg. 54,822 (September 23, 2008).

section F(b) of the *Guidelines* observing that the Director "will issue a written determination . . . within 30 days of receipt of the request," that determination was not issued to the Bank until July 21, 2009, over five months past the February 9 date contemplated by the *Guidelines*. That delay, according to the Bank, specifically violated the strictures set out in the *Guidelines*.

In response to the Bank's challenge that it had insufficient time and opportunity to review the ROE, DSC stresses that, in fact, Bank management was made aware of each of the loans being adversely classified in all of the loan discussions conducted during the Exam, as well as at the ROE Exit Meeting on September 3, 2008, which was attended by President ***, Board Chairman ***, and Chief Financial Officer ***. At the Exit Meeting, all three officers were informed of all weaknesses identified in the Exam, according to DSC, as well as the material concerns of the EIC. Further, the officers were given an opportunity to review the Memorandum of Understanding ("MOU") to be issued to the Bank, which specifically noted weaknesses in asset quality, as well as the need to revise and implement a loan policy and strengthen collection policies and practices. According to DSC, none of the three objected to any of the loan classifications or the ROE findings at the time of the Exit Meeting or during the loan discussions while the Exam was ongoing.

DSC goes on to observe that the Board meeting was originally set for October but was postponed to November, affording the three officers additional time to inform other Board members of the ROE results. As a matter of policy, Board members were invited to all management meetings, including the Exit Meeting, but the three outside directors chose not to participate in that meeting. Finally, DSC notes that, according to the EIC, a general sense of cooperation in and commitments made for corrective action characterized the September 3 Exit Meeting, and that, as noted, there was no indication that management disagreed with any of the proposed ratings.

The record of the case, however, reveals that in early October 2008, the Bank's president did transmit two memoranda to the Field Supervisor and the EIC, an October 1 memo opposing the classifications of all the ABC/*** Family loans, including a 16-unit apartment building, and a second memo on October 3, objecting to the XYZ classification, pointing out that an offer had been tendered on the property securing that credit. DSC acknowledges that no written response was provided to President *** on either of these memoranda before the November 20 meeting with the Board. In fact, as further acknowledged by DSC, there was no written response until December 30, 2008. On that day, the Field Supervisor sent President *** an email apologizing for the delay in adequately responding to the emails but reiterating the FDIC's position that the classified assets were based on a loan review date of July 25, 2008, and that the credits met the criteria for classification despite the additional information provided by management.

Nevertheless, in response to the Bank's January 9, 2009 Request, the Regional Office upgraded two of the loans in the ABC/*** Family relationship, including the $819,000[3] apartment building note, the subject of argument in the October 3 memorandum, and a working capital loan for $45,000. The Regional Office did not upgrade the $639,000 XYZ loan, which was the subject of the October 3 memorandum.

***The Committee's Findings.*** The Bank has three principal procedural objections: (1) it did not have sufficient time to review the Exam before it was finalized, making any "good-faith effort" encouraged by the *Guidelines* to engage in dispute resolution, essentially illusory; (2) DSC failed to respond to the memoranda the Bank transmitted in its effort to memorialize its objections to the classifications; and (3) its Request for Review was not acted on for over five months when the Regional Office issued a preliminary finding on the loan classifications and the composite and component ratings. No decision was issued by the Director for six months, despite the *Guidelines* instruction that the Division Director "will issue a written determination[] within 30 days of the [Request for Review]." *Guidelines* at F(b).

It goes without saying that it is the responsibility of DSC to respond substantively and in a timely manner to the legitimate questions and objections of the Bank and to provide a full and substantive explanation behind its ratings. The Exit Meeting is the formal opportunity to engage in the give-and-take that the *Guidelines* contemplate. This Committee finds that the Bank's management, including the president, the chairman of the Board, and the chief financial officer were all present at, and participated in, the Exit Meeting on September 3, the purpose of which is to discuss in full detail the findings of the examiner in charge. The Bank's outside directors chose not to attend the Exit Meeting, though invited. DSC states, and the submittals of the Bank do not contend otherwise, that each of the ratings and the classified assets were fully discussed, and, according to DSC, there was a general sense of cooperation and commitment made for corrective action on the part of the Bank. Additionally, at the Exit Meeting, the three officers reviewed the MOU, which specifically concerned the asset quality issues. However, communication seems to have broken down following the Exit Meeting.

The Bank maintains that during the Exam, it provided evidence that the ABC/*** Family apartment building was under contract and that the sale would leave the Bank well collateralized. Following the Exit Meeting, the Bank voiced these objections anew in the October 1, 2008 memorandum from the president to the Field Supervisor and the EIC. DSC acknowledges that this memorandum and the one sent two days later (pertinent to the XYZ classification) were not responded to in a timely manner.

***On the Bank's first procedural objection***, the Committee finds that the Bank had ample notice of the findings of the ROE. ***First***, the Bank had opportunities while the Examination was ongoing to disagree with the classified credits during loan discussions

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[3] All loan amounts are rounded to the nearest thousand dollars.

and yet, apparently, chose not to object. ***Second***, Board members had a full opportunity to review and discuss the asset quality issues and the loan classifications at the Exit Meeting. These subjects were discussed in detail, not only in the context of the Exam, but also in reference to the review and analysis of the MOU. ***Third***, the Exit Meeting was on September 3 and the Exam was not transmitted to the Regional Office until September 29, leaving the Board at least seventeen business days to engage in serious dispute resolution. Further, the delivery to the Bank of the Exam on November 18, 2008, constituted the delivery of a signed Examination, not a draft Exam, a process this Bank has been through numerous times in its history. The Bank's apparent assumption that the matter was still open for negotiation when it had a signed Exam in hand was an unreasonable assumption. While section E of the *Guidelines* encourages "informal resolution of disputes with the on-site examiner and/or the appropriate Regional Office," it also clearly states that "seeking such a resolution is not a condition to filing a request for review . . . or an appeal to the SARC under these guidelines." Accordingly, ***fourth*** and finally, the Bank's failure to successfully engage with the EIC in a resolution with respect to the ABC/*** Family, the XYZ loans, or any of the other loans does not and cannot preclude the Bank from filing its Request for Review (in response to which the Regional Office upgraded two loans and the Asset Quality rating), or, for that matter, its appeal to this Committee. There was thus no lasting prejudice to the Bank by the finalization of the Exam before the formal Board meeting.

***On the second procedural point***, DSC's concession that it did not respond in writing in a timely manner to the two October memoranda also troubles this Committee. Although in this situation, the Bank was not disadvantaged – the ABC/*** Family apartment building loan was eventually upgraded, and the XYZ loan was also reexamined as a result of the secondary review conducted by the Regional Office – such failures to respond in writing and in a timely manner are unacceptable.

***On the final procedural objection***, we observe that the fact that the Bank's Request for Review was not finally acted upon for over six months goes unexplained in this record. The Committee notes that the *Guidelines* do not impose any penalty on the Director for failure to meet the 30-day date. Therefore, we find that the lateness of the Director's response caused no hardship on the Bank, and, indeed, the Bank has alleged none. Nonetheless, the Committee is very concerned about this significant delay and with the Division's inability to explain it.

### *B. The Bank's Classified Loans.*

In its appeal, the Bank claims that loans within four loan relationships were inappropriately classified Substandard: (1) ABC/*** Family Relationship, consisting of 6 loans, 4 of which are at issue, totaling $540,000; (2) XYZ, LLC, the obligor on a commercial real estate loan on which $639,000 is owing; (3) QRS Inc./*Mr. Q & Mrs. Q, obligors and guarantors on 3 loans on which $542,000 is owing; and (4) JKL, Inc. & MNO, LLC, with debt at issue comprising a line of credit ("LOC"), 2 small-term loans, and a single-payment note, with $651,000 owing.

The FDIC evaluates an institution's overall financial condition under the *Risk Management Manual*. To quantify the results of a loan appraisal, the examiner must decide which loans will be criticized and/or commented on in the Exam. Adversely classified loans are allocated on the basis of risk, to three categories: Substandard; Doubtful; and Loss. Adverse classifications are confined to those loans that are unsafe for the investment of depositors' funds.

A ***Pass Classification*** is given only to loans that pass without criticism.

A ***Substandard Classification*** signals that the loan is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged. A Substandard loan must have well-defined weakness(es) that jeopardize the liquidation of the debt. It is characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Under the *Risk Management Manual*, the function of the Substandard classification is to indicate a loan that is unduly risky and, if unimproved, may pose a future hazard.

***1. *** ("ABC")/*** Family Relationship.***

*** ("ABC") is the limited liability company used by ***, and *** to hold their real estate. ABC holds six loans, that were originally classified as Substandard, two of which were subsequently upgraded to Pass by the Regional Office following the filing of the Bank's January 9, 2009 Request. The four loans still at issue are: (1) Note 2 for a bakery building, with a balance of $267,000, secured by a first mortgage and with a 2005 appraised value of $350,000; (2) Note 3 for a single-family dwelling, with a balance of $152,000, secured by first and second mortgages and with a 2005 appraised value of $195,000; (3) Note 5, with a balance of $113,000, for a cash-out refinance of a duplex, to buy a home in ***, and with a 2005 appraised value for the duplex of $145,000; and (4) Note 6 for a consumer auto loan, with a balance of $8,000.

***The Bank's Position.*** The Bank contends that at the time of the Exam, all of these loans were adequately collateralized, and the appraisals in place were performed by the Bank's "most conservative and knowledgeable appraisers." In each case, the Bank emphasizes, the balances are exceeded by the appraisals in place. As to delinquencies, the Bank points to cultural considerations that the Bank observes with respect to these long-time customers. The Bank stresses that it has always tried to understand and accommodate certain cultural differences in its efforts to reach the unbanked and Latino populations in the Bank's neighborhood:

> In explanation of the occasional delinquent, late payments and even nonaccruals in the past on these loans, these Latino borrowers do travel to *** several times a year for extended visits. The *** family regularly travel to and visit relatives in their hometown. They also visit their new home or ranch in ***. This is a normal

> part of the culture for Latinos. There have been several occasions when the loans were past due when they were out of the country. However, because the bank is sensitive to these cultural differences and accustomed to [a] Latino world view, the bank would not be overly concerned as it knew the borrowers had the ability and intention to repay.
>
> Upon returning home to the U.S., all loans would regularly and immediately be brought current. While this may not be the preferred method of doing business, Latinos do view their obligations and such actions differently. While not encouraging late payments, the bank tries to be patient and understanding of the Latino nonconventional view of their financial obligations and the difficulties in making cross border payments.

As to the specific assets at issue in the ABC/*** Family relationship:

***Note 2.*** The Bank argues that the bakery business is profitable and able to service the debt. The appraised value yields a loan to value ("LTV") of 76%, well above the Bank's loan policy requirements. Moreover, proceeds from the sale of the 16-unit apartment building paid off an additional $23,000, bringing the LTV below 70%.

***Note 3*** is a residential real estate loan on a single-family residence located in an affluent suburban community in the *** area. The residence is the home of one of the *** family members on which the Bank holds first- and second-mortgage loans. With a balance at Exam time of $152,000 on an appraised property of $195,000, the LTV is just under 78%. The Bank alleges that the loan was classified as Substandard because of "some late payments in the past," protesting that the Bank was working with the family to keep them in the home and mitigate foreclosure "as strongly encouraged by all Federal and State regulators and partners in the current economic circumstances."

***Note 5,*** for a fully occupied duplex rental property, had a balance of $113,000, an appraised value of $145,000, and an LTV of 77%, which, contends the Bank, was also well within the Bank's guidelines for rental property.

***Note 6.*** As a result of the sale of the 16-unit apartment building, this loan, with a balance of $8,000, was paid off in full.

The Bank argues that ABC/*** Family moved aggressively to sell the 16-unit apartment building to remove the debt on their holdings and that the Bank provided evidence of the contract for sale during the Exam. The Bank states that it informed the EIC during the Exam that the sale would eliminate any financial difficulty associated with the ABC/*** Family credits, leaving the Bank well collateralized on the ABC/*** Family relationship. In fact, the Bank notes, as a result of the sale of the apartment building, the consumer auto loan (Note 6) was paid in full and the bakery building loan

(Note 2), the next largest of the credits behind the apartment building, was reduced by $23,000 from the apartment sale proceeds. The Bank insists that the EIC's classification of the entire relationship was improper as based on his conclusion that the personal "guarantees provide limited financial support . . . . and reflect[] no liquidity."

This conclusion, the Bank posits, is evidence that the EIC completely discounted the assets of the principals. However, the sale and consequent debt reduction demonstrate that their "personal guarantees had substance and that they were able to pay down their debt with personal assets . . ." Further, the Bank disputes DSC's assertion that collateral protection "remains questionable . . . given current market conditions," noting that the inaccuracy of the Bank's contention is borne out by the sale of the apartment building, making possible the reduction of debt. Each of the loans, the Bank asserts, has valid appraisals in place, completed by the Bank's most experienced and conservative appraisers.

***DSC's Position.*** DSC counters that all the notes secured by real estate rely on 2005 appraisals, done at the peak of the real estate boom. At the time of the Exam, although the Bank's files lacked current financial information on the ABC/*** Family properties, cash flow appeared strained, as all but one of the notes was either past due or in nonaccrual status:

(1) Bakery building (Note 2), 98 days past due, nonaccrual, real estate taxes delinquent;
(2) Single-family residence (Note 3), nonaccrual, while not past due at the time of the Exam, the property had a history of past-due payment and real estate taxes were delinquent;
(3) Cash-out refinance duplex (Note 5), 43 days past due, nonaccrual, real estate taxes were delinquent;
(4) Consumer auto loan (Note 6), 109 days past due, nonaccrual.

DSC goes on to argue with respect to relying on the sale of the apartment building, that the other loans in the relationship were not collateralized by the apartment building. Had ABC/*** Family wished the Bank to rely on sale proceeds from the apartment building, they were required to memorialize that desire with the public filing of the appropriate security agreement documents, and the Bank was required to record that fact in its records. Moreover, the application of the excess funds from that one-time sale to pay off delinquencies on the other properties (which occurred well after the Exam) cannot provide consistent backing for assets because of the one-time nature of the event. The sale does not address the underlying and severe credit weaknesses of those properties – the past-due, nonaccrual histories, the outdated appraisals (which the Bank had made no attempt to update), the delinquent taxes, and the weak positions of the guarantors.

***The Committee's Findings.*** The Bank pins its arguments primarily on three assertions: (1) that the collateral securing the loans at issue in each case substantially exceeded the loan balances due and that therefore the loans were well collateralized; (2)

that the EIC completely and improperly discounted the assets of the principals and therefore their guarantees; and (3) that the Bank's response to delinquencies was merely indicative of the Bank's efforts to be culturally sensitive.

As to the first argument, the Committee determines that specific and significant evidence of the marked depreciation in real estate values since 2005 (when all of the record appraisals were performed) is found in the sale on which the Bank relies for its argument that the ABC/*** Family credits were well collateralized – the 16-unit apartment building. In fact, the sale price for that building represented a 10 percent loss in value since its 2005 purchase. Moreover, the owners were required to spend substantial sums on maintenance and renovation, according to Bank records cited by DSC. It appears to this Committee that even with these substantial maintenance and renovation expenditures, the owners were unable to recoup their 2005 investment. Finally, the Bank does not respond to the fact that the assets were appraised during a high point in the real estate market in 2005. These facts we find highly probative of the staleness of the 2005 appraisals for the other properties in the ABC/*** Family relationship. Given the decline in the real estate market since the time of the appraisals and the credit weaknesses of the properties, we affirm as reasonable DSC's determination that the loans were not well collateralized.

That the EIC improperly discounted the personal guarantees of the principals also runs counter to the evidence. This record supports the fact that the personal assets of the principals had little value. For its argument, the Bank relies on the very real estate "equity" that has been diminished by the fall of the market since 2005. The Bank cites the sale of the apartment building as evincing the value of that equity. But as this Committee has already ruled, that value is, at best, uncertain. And the facts of the sale and necessary repairs of the apartment building, as we have held, show the fragility of the principals' equity cushion. Finally (and conclusively on this point) the record simply does not demonstrate that the other loans in the ABC/*** Family relationship were collateralized by the apartment building. The Bank had no basis on which to rely on that asset as support for the other loans.

The personal assets of the guarantors are of little additional help. A personal financial statement for Mr. *** and Mrs. *** dated October 2007 and proffered by DSC reflects no liquidity: their assets consist wholly of automobiles and real estate. Bank records, also cited by DSC, disclose that the personal financial statements of the other three guarantors (from February 2004) provide limited support. All of these facts are buttressed by the strain revealed by the past-due and nonaccrual status of the assets and the fact that ABC and Mr. *** are subject between them to over $25,000 in delinquent real estate taxes.

Finally, the Bank's contention that it accepted late payments and nonaccruals in an effort to be culturally sensitive, is not wholly borne out by the record, as detailed by DSC. The Bank appears to have, itself, feared the unsoundness of the backing supplied by the principals:

(1) The Bank's July 24, 2008 Credit Presentation states that the reason for the delinquencies involved problems associated with the apartment building: There have been "turnover of tenants, including evictions, and the costs to rehab vacant units . . . very high repair and maintenance costs. . . . The family does not have the resources to fund these costs. They have used rents to fund the repairs and have [been] past due on our loan as a result."
(2) A Bank file memo dated July 23, 2008 states: "They had enough funds to catch up on two payments . . . but do not have the $30M required to pay all past due payments."
(3) The fact that four of the credits are on nonaccrual suggests a global cash flow problem:[4] A July 30, 2008 Bank file memo indicates, "There is $22,000 of global cash flow before personal debt service, which is not real strong and explains why we have slow payments on these loans."

This Committee acknowledges the Bank's very real and important efforts to serve the Latino community. But the deficiencies described in the ABC/*** Family relationship are more significant than a few late payments. On the basis of all of this record evidence, the Committee determines that the ABC/*** Family loans are appropriately classified Substandard.

### *2. *** ("XYZ"), LLC.*

*** ("XYZ") is a limited liability corporation owned by Mr. X and his wife and guaranteed by Mr. X personally. The Bank holds a $639,000 commercial real estate loan secured by a two-unit combination office/warehouse building located in a local industrial park. In 2004 the Bank committed to a $675,000 construction loan to build the warehouse. When the one-year construction note matured in August 2005, the Bank converted the loan to a three-year note with a 25-year amortization. The loan had a high balance of $675,000 and has since amortized down to the Examination balance of $639,000.

***The Bank's Position.*** The Bank asserts that the risk of the loan has declined significantly since the Bank's original decision to fund the project. The building is fully occupied with five-year leases in place; all rents are current and timely paid. Furthermore, all loan payments over the last four years have been paid "as agreed and on time." According to the Bank, "This is a very nice property in a very desirable industrial park with solid tenants and a good cash flow." The Bank notes that during the Exam, it contacted the appraiser to discuss his original assumptions about value per square foot

[4] "Global cash flow" represents all reliable cash flow from borrowers, guarantors and income produced by a property to support that property.

and rental income per square foot. The appraiser verified that the current rents were very acceptable market rents and confirmed the validity of the original appraisal.

The Bank cites the "examiner's unexamined and undocumented conclusions and speculations that [Guarantor] X's personal guarantee could not support this loan," notwithstanding the existence of five-year leases, solid tenants, and debt-service coverage of at least 98 percent. Additionally, Mr. X had $3 million in cash remaining in August 2008. Further evidence of the guarantor's ability to service the debt, according to the Bank, was his $50,000 equity injection to pay down the loan to $577,000, reducing the LTV to 78%. Acknowledging that the paydown occurred after the loan review date, the Bank maintains that it is relevant evidence, nevertheless, as demonstrative of the value added to the sources of repayment by Mr. X's guaranty. Additionally, this equity injection is indicative of the availability of the guarantor's personal assets "to service this very minor [debt service coverage] shortfall." Most importantly, the Bank urges, it documents the error of the EIC's conclusion that Mr. X's guaranty was compromised.

***DSC's Position.*** DSC responds that although the XYZ building was fully leased, it was not generating positive cash flow. The most recent financial data are company-prepared 11-month interim statements dated November 2007. Management calculated a debt-service coverage ratio of 0.95 for the XYZ buildings. Since the Bank's loan is to the entity that owns the two commercial buildings (XYZ), DSC notes in its loan writeup that a global cash flow analysis is more probative than the debt-service coverage ratio for the two buildings. Bank President *** calculated a global debt service coverage ratio of 0.97 during the Exam, using Bank statements through August 25, 2008. As of November 2007 company-prepared interim statements, assets totaled $2,381,000, liabilities totaled $2,361,000, and equity totaled $20,000. Liabilities include $198,000 due to related companies and $360,000 due to Mr. X.

With respect to the adequacy of collateral protection, an income capitalization approach for the property resulted in a value of $640,000, yet the appraisal listed the market value as $740,000. In consideration of the fact that this is an income-producing property, DSC argues that an income approach to value is a more probative measure of value than the sales approach rendering the $740,000 market value. Moreover, XYZ has been unable to charge the market rents used in the appraisal. Accordingly, the value of the property is probably closer to the value determined by the income capitalization approach and approximates the balance of the loan. Further, the Bank took an impairment of $47,000 on this credit, recognizing that there is potential for loss on the XYZ credit – a condition that meets the definition of Substandard.

At origination, Mr. X's guaranty added substantial support. A personal financial statement for December 2005 listed total assets of $45,786,000, total liabilities of $2,924,000, and $42,862,000 in net worth. Assets mainly consisted of $28,377,000 in investments in various entities, $5,469,000 in listed securities, $4,356,000 in receivables, $3,990,000 in real estate, and $527,000 in cash. Mr. X had an ample source of liquid assets. Yet his financial condition has since deteriorated considerably: in October 2007,

his trucking companies filed for a liquidating bankruptcy. A major portion of his net worth was the equity in these companies (approximately $20 million). In addition, he personally guaranteed the debt of his trucking companies. Mr. X estimates that he injected about $7 million of his own cash into the companies from 2007 to 2008. Although a current personal financial statement has not been provided, he has indicated, as of August 2008, that he has approximately $3 million in cash remaining. He has also stated that he is a defendant in two remaining lawsuits (with *** and ***) growing out of the bankruptcies.

Finally, Mr. X's personal financial position eroded further in June 2008, when another financial institution foreclosed on two large office buildings owned by him in the same industrial park as the ***. Mr. X guarantees the debt on these entities, totaling $5.2 million.

***The Committee's Findings.*** The XYZ property appears to this Committee to be significantly overvalued. Although the building is fully leased, it is not generating positive cash flow, a fact buttressed by the market value of the building as figured by the income approach – $640,000, a full $100,000 under the market value as calculated under the sales approach. As an income-producing property, the income from which is a vital indicator of its value to both its owner and to the Bank itself, the property is appropriately valued using the income approach, especially considering the fact that the evidence, as pointed out by DSC and unrebutted by the Bank, suggests that the current market would not even sustain the market rents used in the income approach rendering the lower market value of $640,000. The Committee also takes note of the Bank's recognition of a $47,000 impairment on the building. Under the *Risk Management Manual*, a Substandard classification "is characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected."

A global cash flow analysis includes liabilities of nearly $200,000 due to related companies, as well as $360,000 to Mr. X, himself, yielding a debt-service ratio of 0.97, a number that indicates distress. Finally, the diminution of the net liquid assets of Mr. X (both a principal and the guarantor for the loan) from nearly $10.4 million in 2005 ($527,000 in cash; $5.5 in listed securities; and $4.4 in receivables) to $3 million in less than three years cannot be ignored and is a fact that this Committee deems corroborative of its finding on the loan relationship as Substandard.

The Committee finds that the Substandard classification for this asset is warranted based on the company's tight collateral position, the precarious global cash flow position, and the weakened financial condition of the guarantor as a result of the bankruptcies of his trucking companies, the unsettled lawsuits arising from the bankruptcies, and the recent foreclosures on other office buildings of which he is guarantor.

***3. *** ("QRS"), Inc./*** ("Mr. Q") &***(" Mrs. Q").***

*** ("QRS") is a retailer of barbecue gas grills, outdoor gas fireplaces, smokers, and fryers. The business is equally owned by *** ("Mr. Q"), and his mother *** ("Mrs. Q". QRS has been in operation since 1960. The two owners also operate ***, a catering business that derives its principal source of revenue from selling food and beverages at the state fair. The income from the catering business is included as part of the income of QRS.

There are three notes at issue in the loan relationship. Note 1, to refinance debt from another institution, carries a balance of $252,000; Note 2, for $255,000, represents a working capital LOC; and Note 3, for $65,000 on payables. All three notes require monthly interest payments, and Note 1 requires an annual principal payment of $18,000, generally made up from sales of food and beverages at the state fair. Notes 1 and 2 are secured by first and second mortgages on the business's commercial building, a first mortgage on a residential rental owned by Mrs. Q, a junior mortgage on Mrs. Q's personal residence, and the inventory of the business. Note 3 is secured by a first mortgage on a lot in ***, ***, also owned by Mrs. Q. The lot has a 2008 assessed value of $93,000

***The Bank's Position.*** The Bank argues that the EIC improperly failed to consider in his collateral analysis the "additional and marketable company-owned asset consisting of a restaurant building and related equipment on the *** State Fair grounds" (the "Fairgrounds Assets"). The Bank alleges that the value of the asset is "at least $250,000 and perhaps $300,000 to $350,000, based on the bank's knowledge of recent sales of comparable properties, equipment and State Fair businesses." The Bank states further that the building and equipment are encumbered under the Bank's general business security agreement ("GBSA"), dated December 2003, adding that "to further document and confirm this marketable asset as collateral, the bank has had the borrowers sign a new and separate security agreement in December 2008."

The Bank contends that the EIC's failure to consider and credit this "overlooked asset with a conservative value of $250,000" ignores an asset that substantially eliminates any possible risk in the entire relationship. The Bank argues it has executed a new security agreement (dated December 2008) that documents the asset as collateral.

The Bank goes on to assert, in direct response to the operating losses suffered by QRS, that in the last three years, the Bank has taken additional collateral to support the loans – liens on Mrs. Q's personally owned real estate (net collateral value $108,880); on a commercial building (net collateral value $376,000); a 2$^{nd}$ lien on rental property (net collateral value $31,380); and a lien on residential lots in *** (net collateral value $74,784). Additionally, the Bank points out that its GBSA covers all business assets of the company (net collateral value $25,000).

***DSC's Position.*** First and foremost, DSC points out that, as of the Exam date, the company was in liquidation, and one of the three notes was past due 42 days. The company reported net losses of $92,000, $56,000, $93,000, and $13,000 for the 12-months ending 2004, 2005, 2006, and 2007. The March 31, 2008 financial statements reflect a $60,000 net loss through the first three months of 2008, and a deficit equity position of $225,000. After adjusting for notes payable to the principals, the deficit equity position is $91,000.

The examiners noted the declining value of the business based on the history of losses, the negative equity position, and the lack of support offered by the guarantors. Also, the principals in the business have been depleting their personal assets to keep the business afloat and loan payments current, as indicated by the additional extension of $65,000 by Mrs. Q in March 2007 to bring the business payables current and the rising credit card debt for Mr. Q. Mr. Q's credit card debt increased by $25,000, to $74,000, from May to July 2008. Mr. Q would be required to liquidate all of his liquid assets to cover this revolving debt, an effort that could be insufficient. Mrs. Q's assets primarily consist of real estate pledged for the business loans. DSC contends that, given the company's liquidation, there are no current appraisals (or current valuations of any kind) on the properties, and the guarantors offer no further support. Accordingly, the EIC correctly questioned the Bank's discounted LTV analysis, which indicates that the Bank has sufficient excess collateral.

Furthermore, DSC notes that it cannot consider the Fairgrounds Assets as the Bank neither mentioned the property during the Exam nor included it in their collateral analysis. The Bank relies on their 2003 GBSA, which covers business inventory, but that security agreement was at no time mentioned during the Exam nor made a part of the Bank's collateral analysis. Additionally, the Bank has since proceeded to obtain a new GBSA, which specifically includes the Fairgrounds Assets, but that security agreement is dated December 2008, long after the close of the Exam.

DSC maintains that the Bank failed to acknowledge that the first mortgage on the commercial building, with a listed net collateral value of $376,000, was for $325,000, and that there are intervening (senior) liens from Mr. Q and the City of ***, ***. The balance of these liens totals $31,000, reducing the Bank's collateral protection on its first and second mortgages to $345,000. Additionally, the original valuation on this property is from a 2003 appraisal and must be considered stale. The value assigned to inventory ($50,000) was estimated by the borrower and unverified. Because the business is in liquidation, the value assigned to collateral is considered suspect. The values of Mrs. Q's residence and rental property ($108,880 and $31,380, respectively) were the result of 2006 assessments, and, given the deterioration in the real estate market since that time, these values, too, may be high. Use of the assessed values for the *** lots ($74,784) is likely generous as there has been significant deterioration in the *** market. Mrs. Q valued these lots at $60,000 in 2004, a value DSC believes is more realistic, given the sharp market swings in ***.

***The Committee's Findings.*** With regard to the inclusion of the Fairgrounds Assets as collateral for the QRS loans, the record does not demonstrate that the Bank counted these assets as collateral at the time of the Exam. The filing of the new security agreement in December 2008 was long past the closing of the Exam and accordingly cannot be considered.

The numbers for the additional collateral in the form of liens taken out by the Bank simply do not work out. The Bank's collateral analysis relies on old appraisals, assessments, and the verbal statements of the borrowers who are in liquidation. The business has an extensive history of net losses, and it appears that the principals have valiantly attempted to keep things afloat in a bad market by plowing their personal (and diminishing) assets into the business. The business is in liquidation, the collateral at the time of the Examination was insufficient to cover the debt, and the guarantors are unable to offer further support. This relationship is characterized by the distinct possibility that the Bank will sustain loss if the deficiencies are not corrected. The loans are properly classified Substandard.

### *4. *** ("JKL"), Inc. & *** ("MNO"), LLC.*

"JKL" is a distributor of paper products; cleaning materials and chemicals; and shipping and packaging supplies. Approximately 90 percent of JKL's sales represent sales to end users, and the other 10 percent, promotional goods. JKL's end-use customers include manufacturers, hotels, bars, restaurants, gas stations, and government entities, among others. The company is Native American-owned, operated, and certified as a minority-owned company doing business with *** governmental entities. Indian ownership assists JKL in reaching Indian casinos, tribal governments, clinics, and schools. The company has over 600 customers, 200 of whom are active on a recurring basis. The owner, *** ("Mr. K"), has been in the industry for over 20 years and worked for a competitor for 16 years before starting his own minority-owned business. Debt for the relationship includes a $325,000 LOC with a balance of $323,000 at the time of the Examination, a commercial real estate mortgage for $296,000, and three small loans totaling $32,000.

***The Bank's Position.*** The Bank has provided banking services for the business since January 2004. Over the five-year period, all loans have been paid as agreed. MNO, LLC, holds title to the commercial real estate property that secures a portion of JKL's debt. The loan, which is over six years old, has an LTV of 77%, according to the Bank. Although acknowledging that there have been recent downturns in real estate values, the Bank challenges DSC's use of a 5-year-old appraisal rather than the more recent 2006 document for valuing collateral:

> [R]eal estate was appreciating over the early years of this loan and the 2006 appraisal by a certified appraisal cannot be dismissed without some basis or compelling reason. The Division's suggestion that a 2003 versus 2006 appraisal should be used to

> assess collateral is unsustainable and a transparent attempt to protect its own examiner who applied a very heavy hand to this loan relationship.

Further, the Bank contends that the LOC was adequately covered by a collateral base formula of 80 percent accounts receivable and 50 percent inventory, which consists of all finished nonperishable goods and does not include work in progress.

Admitting that the operating company (JKL) has a negative net worth, the Bank maintains that JKL was a start-up minority business and losses in the first few years were the cause of negative net worth. The Bank continues that losses during the early years of a new business are not unusual, and that fixed start-up expenses, including heavy payroll, equipment expenses for the warehouse, computers, and such necessaries as the ordering of inventory tracking software, took their toll but were essentially one-time expenses. JKL posted a profit in 2007 and the first seven months of 2008. The Bank contends that its loan amounts and exposure have not increased over the last several years, but that JKL has benefited from a minority-friendly lender – *** ("Company X"). A CDFI,[5] Company X makes loans to Indian-owned businesses for working capital and has lent JKL $81,000, further mitigating the Bank's risk.

The Bank describes itself as active in monitoring the status of its loans: for the last three years, the Bank has been supplied with monthly balance sheets, income statements, and accounts-receivable and accounts-payable documentation. The LOC has been "appropriately utilized and collateralized."

***DSC's Position.*** DSC acknowledges that JKL's debt service coverage ratios exceeded 1.0 on the Examination date. The Division also points out that positive earning in 2005 resulted from a significant decline in operating expenses, which is not explained in the Bank file, and, in fact, the operating expenses reverted upwards the following years. With respect to the collateral coverage for the commercial real estate loan held by MNO, DSC argues that the property's 2003 appraisal of $273,000 would have left the Bank short on collateral. The 2006 appraisal for $380,000, DSC contends, was performed at the height of the market and simply does not reflect an accurate market value for 2008. Moreover, the Bank took a second mortgage on Mr. K's condominium, which was previously appraised at $172,000. The date of the appraisal is not recorded; the property was reappraised in 2006 for $210,000 and is subject to a first mortgage of $120,000. This appraisal, also, was done at the height of the real estate market, DSC argues, calling its present validity into question.

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[5] The Community Development Financial Institutions Fund was created to promote economic revitalization and community development through investment in assistance to community development financial institutions. The CDFI Fund was established by the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, 12 U.S.C. §§ 4701 *et seq.* The Fund is administered by the U.S. Treasury.

The June 2008 financial statement for JKL shows total assets of $652,000, total liabilities of $774,000, yielding a deficit net worth of $122,000. For the past three years, minimal profits have provided inadequate debt service coverage – in the 0.6 to 0.7 times range. According to financials, company debt rose by $174,000 from December 2004 to June 2008, which funded an increase in inventory of $151,000 and a decrease in net worth of $27,000. As of October 2007, Mr. K's total assets were $965,000, total liabilities were $560,000. Although the principal's net worth is $404,000, Mr. K has $59,000 in credit card debt, and his net worth is largely made up of real estate equity of $125,000, retirement assets of $132,000, and JKL (valued at $100,000), all of which are already pledged or not subject to attachment.

DSC believes that the collateral coverage is extremely tight on the JKL loans. Citing the most recent financial statement from JKL of June 30, 2008, DSC notes that examiners calculated accounts-receivable at $130,400 and inventory at $205,000, for a discounted total collateral value of $335,400, based on a loan balance on the Exam date of $323,256. The coverage ratio is calculated on those numbers at 1.04.

***The Committee's Findings.***

The Bank's challenge to DSC's use of a 2003 appraisal rather than the more recent 2006 appraisal is well taken. However, this Committee finds that there ***is*** a compelling basis for the Division's rejection of an appraisal done at the top of a steep market that was in free fall by 2008. This reasoning must be applied equally to the appraisal on Mr. K's condominium. And these facts point up the danger in the Bank's deficient loan review policy. The Bank seems to have fairly consistently failed to obtain reappraisals on deteriorating loans to support impairment analyses. In fact, this record documents in a Bank December 2007 memorandum, the Bank's discomfort with the profit level of the business, making the collateral valuation of this asset all that more crucial.

In addition, and unfortunately, JKL has an increasing level of negative net worth that the Committee cannot discount. That net worth, totaling ($122,000) as of June 2008, a history of weak earnings, tight collateral coverage, an increasing level of "days of inventory" and "days of payables,"[6] are all indicative of troubled times for the company. Record evidence suggests that the higher inventory levels are ***not*** associated with significant increases in sales, and, accordingly, the Committee finds that the high numbers must be attributed to weakening performance.

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[6] Days of inventory ("DOI") and days of payables ("DOP") are financial measures of a company's performance. DOI represents the number of days that inventory is on hand and the number of times it rolls over in a measured period. Generally, a lower number represents greater efficiency, although it can mean that a business is not keeping adequate inventory on hand to satisfy sales. DOP is a measure of how long a company is taking to pay its trade creditors. Here, too, a smaller number is generally better – an indication of efficiency and performance.

The fact that Mr. K secured an $86,000 loan from Company X, junior to the Bank's lien on business assets, provides the business with needed cash flow and is, indeed, helpful. And the fact that JKL has recently turned a modest profit is also good news. But that profit follows prior years of operating losses. The Bank recognized this precarious position in the December 2007 memorandum proffered by DSC and referred to above, documenting that the Bank specifically recognized that the business was less profitable than it would have predicted. The Committee finds credible DSC's observation that the principal's net worth is heavy on real estate equity, retirement assets, and the value of JKL itself. As all of these assets are already pledged or are not subject to attachment, we find Mr. K's net worth precarious. JKL's tight collateral coverage, its increasing level of negative net worth, and the history of weak earnings and performance form the basis of the Committee's decision to uphold the Substandard classification for this asset.

### *C. The Safety and Soundness Material Supervisory Determinations.*

The Bank disputes its Composite rating, as well as its component ratings for Asset Quality and Capital Adequacy. The Bank seeks a "2" for Asset Quality, a "1" for Capital, and a Composite rating of "2."

#### *1. Asset Quality.*

Under the Federal Financial Institutions Examination Council's Uniform Financial Institutions Rating System (the "FFIEC Rating System"), 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 allowance for loan and lease losses ("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 2*** indicates satisfactory asset 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's 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:*** While acknowledging that it has experienced "some stress" in its loan portfolio, the Bank contends that it has prudently identified and monitored all stressed credits and expanded its Watch List. No loans not identified on the Watch List were criticized in the ROE. Pointing out that the Asset Quality rating is intended to reflect the quantity of existing and potential credit risks association with ***both*** the loan and investment portfolios, the Bank emphasizes that virtually its entire investment portfolio is in short-term certificates of deposit in FDIC-insured institutions. The Bank holds ***no*** toxic or substandard assets as investments.

The Bank additionally stresses the adequacy of its loan loss reserve – a specifically identified factor to be considered in its Asset Quality rating. The Bank notes that, although it has recently expanded its Watch List, none of the credits are impaired. Further, the Bank argues that its assets are well diversified and that the Bank has actively monitored and appropriately managed its concentration in commercial real estate.

Finally, the Bank states that the EIC's "inappropriate downgrade of the four large credits [ABC/*** Family, XYZ, QRS, and JKL] . . . was the most significant factor" in the downgrade of its Asset Quality rating. The total loans in the four relationships represent nearly half of the classified assets and elimination of their downgrades would reduce the ratio of classified assets to capital from 72 percent to 35 percent.

***DSC's Position.*** DSC cites factors from the *Risk Management Manual* to be considered by an examiner in assessing a bank's Asset Quality performance. DSC argues that the Bank has failed to meet the standards set for a satisfactory Asset Quality rating.

***(1) Adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices.***

DSC contends that the Bank's credit administration policies have not been satisfactory. The Bank has failed to adequately document the rationale for and the management of Watch List credit plans. The Bank has not updated its loan policy since 2001. That policy lacks guidelines for the use of appraisals and appraisal review. It lacks standards for internal real estate appraisals and internal loan review guidelines. The Bank failed to obtain reappraisals on deteriorating loans to support its impairment analyses, and it has failed to implement a comprehensive loan review function or to amend the loan policy to address these issues. Specifically, no written criteria exist that define, identify, or establish test procedures for loans subject to impairment analyses.

Further and crucially, the ALLL adequacy determination calculation in existence at the time of the Exam consisted of three calculations based on three different methodologies. This attempt at a methodology failed to consistently implement the guidelines provided by FASB Statement 5 (Accounting for Contingencies) and FASB Statement 114 (Accounting by Creditors for Impairment of a Loan). The Bank's external

auditors provided the analysis most consistent with the guidelines. Nevertheless, it was not used in the quarterly ALLL adequacy determination.

***(2) The level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions.***

According to DSC, the deteriorating asset quality is demonstrated by:

(a) The increased volume of classifications. This volume increased to 72.18% of Tier 1 Capital + ALLL from a level of 4.75% at the last State Examination;
(b) The trend in delinquencies, now of supervisory concern. The trend rose from low to upper 3% of loans during the period from 2004 to 2006, to 9.71% as of December 31, 2007;
(c) The volume of nonaccrual and past-due of over 90 days, increased from 1% during the period from 2004 to 2006, to 3.01% as of December 31, 2007;
(d) The past-due and nonaccrual ratio for the 2005 Examination of 3.43; for the 2006 Examination, 3.78; and for the 2008 Examination, 7.61; and
(e) The ALLL, at a historic high of 1.72% of loans, from a previous average of approximately 1.0%.

***(3) The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit; the diversification and quality of the loan and investment portfolios.***

The Bank's concentration in commercial real estate as of March 31, 2008, totaled 265% of capital. That level was not criticized in the Exam. However, DSC argues that the quality of the loan portfolio had clearly deteriorated since the last State examination conducted in February of 2007. The Division points out that the deteriorating economy has affected many of the Bank's borrowers as demonstrated by lower rents, increased vacancies, and lower profits. The combined effect of this marked deterioration is a significant lowering of real estate values (*i.e.*, collateral) and insufficient cash flow to keep loan payments current.

***The Committee's Findings.*** The Committee upholds the Asset Quality rating of 3 on the basis of its credit administration practices, its underwriting standards, and its deteriorating asset quality, as explicitly detailed in DSC's presentation. While we note with approval the general balance of the Bank's investment portfolio, which is diversified

and low-risk, the Committee observes with concern (1) the loan policy not updated since 2001; (2) the lack of guidelines for appraisals; (3) the failure to update appraisals in the face of a faltering economy and evidence of distress for individual loans, or at the time of renewal; and (4) the marked deterioration in asset quality revealed both in their increased volume and trend. The failure to update appraisals where loans are not performing results in a lack of specificity in the Bank's impairment analyses. The ALLL methodology in use at the time of the Exam placed the Bank in contravention of the Interagency Policy Statement on the Allowance for Loan and Lease Losses. FIL 63-2001 (July 25, 2009). Management did not develop a comprehensive policy for the ALLL consistent with the guidance provided by the Financial Accounting Standards Board until after the Exam.

### *2. Capital Adequacy.*

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; the quality and strength of earnings, and the reasonableness of dividends; 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 capital level relative to the financial institution's risk profile.

***The Bank's Position.*** The Bank argues that as of September 30, 2008, its total risk-based capital ratio was 16.85%, and by November 24, 2008, 17.21%. Additionally, the Bank's holding company provides significant capital support available to the Bank, a vital factor, according to the Bank, that went unconsidered by the EIC. Moreover, the capital of the Bank and its holding company is all preferred common equity, with no debt-like features. The Bank carries no intangible assets, no goodwill, and has no significant risks associated with nontraditional activities. The Bank has no plans for growth; its asset base is declining and will continue to do so into the foreseeable future. This decline will result in continuing increases to the capital ratios. The Bank additionally cites the fact that it has declared no dividend in 2008 and is prevented from doing so by the MOU. All of these facts, the Bank contends, will result in continuing increases to the capital base "of an already overcapitalized bank and parent company."

***DSC's Position.*** DSC asserts that the types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain

capital at levels above required regulatory minimums to reflect accurately the potentially adverse consequences these risks may exert on an institution's capital. The Division argues that the Bank has failed to meet the standards set for a strong Capital level rating of "1" in relation to the Bank's risk profile.

***(1) The level and quality of capital and the overall financial condition of the institution.***

The Bank had a Tier 1 leverage ratio and a total risk-based capital ratio of 11.45% and 15.65%, respectively, as of March 31, 2008. Peer ratios were 9.94% and 15.28%, respectively, as of March 31, 2008. Although peer capital ratios were not significantly lower than the Bank's ratios, other peer earnings and asset quality indicators were more favorable. Most institutions have tried to increase their capital levels in response to the poor economic conditions. The Bank's argument that their capital levels are strong is unsupportable.

***(2) The nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves.***

The Bank has a high level of classified assets, concentrated in commercial real estate. The trend of problem assets is increasing rapidly; there are rising delinquencies, including nonaccrual and past-due in excess of 90 days, and a recent rise in provision expenses. Provision expenses in the first quarter of 2008 increased 114% from the previous year. Loans and leases in nonaccrual status have increased $2.94 million from the previous year. The elevated provision and overhead expenses (consistently exceeding peer) are primary contributing factors to the Earnings downgrade and the heightened risk profile. The ALLL was originally deemed insufficient during the Exam because of an inadequate methodology; management corrected the underfunding though not the methodology itself until after the Exam.

***(3) Balance sheet composition, including nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities; risk exposure represented by off-balance sheet activities; the quality and strength of earnings; and the reasonableness of dividends.***

Earnings have been weakened by increasing provision expenses resulting from the deterioration in the loan portfolio; contraction in the net interest margin ("NIM") resulting from an asset-sensitive position; and traditionally high overhead expenses.

***The Committee's Findings.*** The Committee upholds the Capital rating of "2" indicating a satisfactory capital level relative to the Bank's risk profile. This satisfactory rating reflects such strengths as the availability of $5 million from the Bank's holding company for infusion if needed; the nature of the capital held by the Bank and its holding

company – *i.e.* preferred common equity; and the fact that the Bank carries no intangible assets and has no significant risks associated with nontraditional activities. Nonetheless, these strengths are unfortunately accompanied by significant weaknesses. A "strong" Capital rating simply cannot be sustained in view of the Management and Earnings weaknesses revealed by the "3" ratings in both of these areas, discussed in the Exam, and undisputed by the Bank. The Bank's high level of classified assets, concentrated in commercial real estate is of consequence in the Bank's Capital rating. Further, we consider the rising level of problem assets and the increasing number of delinquencies. As demonstrated in the ROE and argued by DSC, loans and leases in nonaccrual status have increased $2.94 million from the previous year. The fact that provision expenses in the first quarter of 2008 have increased 114% from the previous year (a fact to which the Bank has offered no rebuttal, is additional evidence that the Bank's Capital is not "strong," as required by a "1" rating. These provision expenses have consistently exceeded peer. We note that the Bank's reliance on November 2008 risk-based capital levels cites evidence outside of the Exam period and cannot be considered.

### *3. The 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.

***DSC's Position.*** With regard to the overall condition of the institution, the Bank has failed to address the severity of weaknesses in the Information Technology ("IT") and Bank Secrecy Act ("BSA") areas. These weaknesses increase the risk exposure of the Bank and contributed to the Composite rating of "2." IT risk-management practices are largely incomplete and have resulted in substantial noncompliance with the Information Security Standards:[7]

- IT risk-assessment process fails to identify threats and vulnerabilities; estimate the likelihood and impact of those vulnerabilities; require the timely production of a Board report on the status of the information security program (one has not been produced since September 2005 (*noted at the last FDIC exam)); develop an incident response plan to address the handling of a security breach;
- Audit risk assessment and audit plan have not been developed (*noted at the last two regulatory exams); audit coverage has been limited to annual ACH self audits;
- Inadequate segregation of duties have been noted over IT core application system administration and security reviews; formal business continuity plan has not been drafted (*noted at the last exam); and
- Backup media rotated off-site is infrequent and insufficiently protected from physical environmental threats during transit; server room lacks fire suppression and heat/smoke detectors.

The overall administration of the Bank's BSA and Anti-Money Laundering compliance program needs improvement. Serious deficiencies were noted; apparent violations were cited regarding independent testing and suspicious activity reporting. Weaknesses were also noted in the areas of suspicious activity monitoring, customer due diligence, and the risk assessment.

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[7] 12 C.F.R. pt. 364, app. B. The Interagency Guidelines Establishing Information Security Standards ("Security Standard Guidelines") set forth standards pursuant to section 39 of the Federal Deposit Insurance Act ("FDI"), 12 U.S.C. p—1 and sections 501 and 505(b) of the Gramm-Leach-Bliley Act ("GLBA"), Pub. L. No. 106-102, 15 U.S.C. §§ 670 *et seq. See, in particular*, 15 U.S.C. §§ 6801 and 6805(b). The Security Standard Guidelines address standards for developing and implementing administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of customer information. They also address standards for the proper disposal of consumer information under sections 621 and 628 of the Fair Credit Reporting Act ("FCRA"), Pub. L. No. 90-321, 15 U.S.C. §§ 1681 *et seq. See, in particular*, 15 U.S.C. §§ 1681s and 1681w.

***The Committee's Findings.*** the Bank's appeal contains no specific argument supporting its request for an upgrade of its Composite rating from "3" to "2" other than asserting that the downgraded component ratings resulted in the downgrading of the Bank's Composite rating. We observe that the Bank did not appeal either its Management or its Earnings ratings (both "3s") – ratings that are critical factors in the Bank's overall Composite rating. These two ratings, paired with the Asset Quality rating of "3" are certainly indicative of supervisory concern, which is the hallmark of a Composite "3" rating.

Finally, of specific consequence are the noteworthy IT and BSA weaknesses. The ROE reveals that an IT exam and a BSA assessment were conducted concurrently with the risk management examination, resulting in a Composite "3" rating for IT and unsatisfactory assessment for BSA. While the impact of these judgments is reflected in the Management component rating of "3" (not contested by the Bank), the weak risk management practices in these areas also contributed to the Composite rating of "3." At the time of the Exam, the Bank was in substantial noncompliance with the Security Standard Guidelines and accordingly put the security, confidentiality, and integrity of its customers' information at risk. And to further exacerbate this situation, the Bank has failed to heed repeated warnings of its failures in these areas. In sum, the Bank has failed to sustain its burden of proof, and the Committee affirms the Composite rating of "3."

## *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 March 25, 2010.

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Valerie J. Best
Assistant Executive Secretary