Decision of the

Supervision Appeals Review Committee

In the Matter of * * *

Case No. 2014-01

I. Summary of Findings.

After consideration of the timely filed written submissions of the parties, the record of this case, and following the May 8, 2014 deliberative meeting of this Committee, we have denied the Bank's appeal. For the reasons set forth in this decision, the Committee upholds the decision of the Director, Division of Risk Management Supervision that affirmed two disputed material supervisory determinations: the Management Component Rating and the Composite Rating. These ratings, assigned following the March 4, 2013 examination are consistent with FDIC policy and practices and are well-supported by the facts and issues documented in the Report of Examination.

II. Background.

A. Procedural Background

This appeal arises from disputed material supervisory determinations set forth in the joint examination of * * * ("the Bank"), * * *, conducted together by the FDIC's * * * Regional Office (the "Regional Office") and the [State banking authority]. The joint examination, which started on March 4, 2013, resulted in CAMELS ratings of 224212/3.[1] The Report of Examination also included an IT assessment and rating of "3," identified a number of apparent violations of Section 23B of the Federal Reserve Act, and found that the Bank, which had been operating under a Memorandum of Understanding ("MOU") requiring correction of certain management deficiencies from a prior exam, had met only 5 of 12 requirements. On September 13, 2013, the Bank filed a Request for Review with the Director of the Division of Risk Management Supervision ("RMS" or the "Division"). The Bank contested its Management rating and its Composite rating.

On October 25, 2013, the Director of RMS affirmed the decision of the Regional Office, determining that the disputed ratings were consistent with FDIC policy and existing examination guidance, and appropriate, given the facts available at the time of the March 2013 joint examination. While upholding the assigned Management and Composite ratings, the Director found that certain undocumented expenses dating to 2011 were not evidence of safety and soundness violations for the relevant examination period, and that the Bank had met 4 additional

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

provisions of the * * * MOU. The Director instructed that the Report of Examination be revised to reflect these findings.

The Bank timely filed an appeal with the Supervision Appeals Review Committee by letter dated November 22, 2013. After additional correspondence with the Committee regarding exhibits, and extension of the filing deadline, the Bank refiled its appeal by letter dated February 24, 2014. [2] The Bank contests the RMS Director's affirmation of its "4" rating for Management from the March 2013 joint examination, seeking a change to a "3." It also contests the RMS Director's affirmation of the "3" Composite rating, seeking a change to a "2."[3]

In accordance with the *Guidelines for Appeals of Material Supervisory Determinations* ("*Guidelines*"), the Committee reviewed this appeal for consistency with the policies, practices, and mission of the FDIC, and the reasonableness of and support for the positions of the parties. The Committee met to consider the appeal and to hear oral presentation from the parties on May 8, 2014. The Committee has carefully considered the written submissions and the oral presentations 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 March 2013 joint examination.

B. Factual Background

The Bank, a state non-member bank chartered in * * *, has been supervised by the FDIC since its conversion from a national bank charter. The Bank is a $* * * million institution, and its main business lines are commercial and real estate lending. It is a wholly-owned subsidiary of a closely-held one-bank holding company, * * *. * * * is predominantly owned and controlled by the * * * family, directly and through trusts.

Several of the March 2013 joint examination findings that are the subject of this appeal are rooted in the Bank's alleged failure to adequately address weaknesses identified in 2010 and 2012 examinations and failure to comply with an MOU entered into * * * as a result of findings from the 2010 examination. In its December 2010 FDIC examination, the FDIC assigned the

[2] The Bank's original filing included a number of documents that were not submitted to the Director of the Division of Risk Management Supervision in connection with the Bank's request for review, as required by the *Guidelines for Appeals of Material Supervisory Determinations*, 77 Fed. Reg. 17055 (Mar. 23, 2012) (available at: http://www.fdic.gov/regulations/laws/sarc/sarcguidelines.html). Section I of the *Guidelines* provides: "Only matters previously reviewed at the division level, resulting in a written determination or direct referral to the SARC, may be appealed to the SARC. Evidence not presented for review to the Division or Office Director may be submitted to the SARC only if authorized by the SARC Chairperson." Other documents were dated subsequent to the time period of the March 2013 joint examination. The Bank was permitted to refile its appeal consistent with the SARC *Guidelines*, but chose instead to resubmit it in its original form. The Committee agreed to accept the appeal but exclude exhibits that were outside the scope of review as described in the *Guidelines*.

[3] The Bank indicates in its appeal that it is contesting four material supervisory determinations: the Management and Composite ratings, a finding of apparent violations of Section 23B of the Federal Reserve Act, and its assigned Information Technology rating. However, in its request for review before the Division Director dated September 13, 2013, the Bank challenged only the Management and Composite ratings, arguing that the issues concerning Section 23B and the Information Technology rating supported the Bank's position. While the Bank's appeal is limited to the material supervisory determinations challenged in the request for review, the Committee has considered the arguments relating to Section 23B and the Information Technology rating to the extent they support the appeal.

Bank a "3" rating for Management based on findings of poor controls over CEO and President * * *'s expenses, inadequate managerial staffing and oversight, and inadequate policies regarding conflicts of interest. As a result of these findings, the Bank was required to enter into an MOU * * * that, among other things, required the Bank to undergo a forensic analysis of insider expenses and to comply fully with the recommendations of a required management study. The required audit found that [a board member had charged significant expenses to the Bank and was unable to substantiate most as Bank expenses]. The Bank's board of directors ("Board") retroactively approved all the charges identified in the audit. At the Bank's February 2012 joint FDIC and [State banking authority] examination, its Management component was downgraded to a "4." The Report of Examination cited deficiencies in oversight of insider transactions, including over $* * * million in unsecured debt issued to Chairman * * *. The Report of Examination for the March 2013 joint examination cites failure to comply fully with terms of the * * * MOU and failure to enact management reforms needed to address the findings of the 2010 and 2012 examinations pertaining to the weaknesses and deficiencies in the Board's oversight functions.

Similarly, the Report of Examination for the March 2013 joint examination notes that some of the apparent violations of Section 23B of the Federal Reserve Act cited in that examination were previously identified in the October 2012 visitation but remained uncorrected. RMS points out that a September 25, 2012 letter to the board of directors of * * * [Holding Company], from the Federal Reserve Bank of * * * identified a number of transactions between the Bank and various affiliates that had inadequate documentation. The holding company was instructed to update written agreements between the Bank and its affiliates to properly capture the transactions, and to "maintain documentation to support that the price charged for these services does not exceed actual cost or fair market value." A January 13, 2013 letter to the Bank's Board from the FDIC and the [State banking authority] summarizing the findings of the October 2012 visitation identified the same transactions as apparent violations of Section 23B and instructed the Bank to "document the fees paid to ensure the rate is comparable with what could occur with a nonaffiliated company." These transactions and the fees paid remained undocumented at the March 2013 joint examination and were identified as apparent violations of Section 23B.

C. Summary of Bank's Contentions

In its written submission, and at the May 8, 2014 oral presentation, the Bank contended that the Composite "3" rating does not reflect the true condition of the Bank. Specifically, it argues that the Composite rating is supported only by the Management component "4" rating, and this component rating is the result of personal bias of FDIC staff against CEO * * * and the FDIC's misunderstanding of the requirements of Section 23B of the Federal Reserve Act. In its written submission, the Bank also argues that other weaknesses cited in the Report of Examination for the March 2013 joint examination, including compliance and information technology issues, are not sufficient to support the assigned Management component and Composite ratings.

III. Analysis.

Section 23B of the Federal Reserve Act

The Bank argues that the Management component "4" rating is inappropriate because it is grounded almost entirely in a misapplication of Section 23B of the Federal Reserve Act. The Committee finds no such misapplication. Moreover, even in the absence of the apparent Section 23B violations, there is reasonable justification for the assigned rating.

Section 23B of the Federal Reserve Act, which is made applicable to non-member banks by Section 18(j)(1) of the Federal Deposit Insurance Act, provides that covered transactions between a bank and an affiliate must be on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with, or involving, nonaffiliated companies. The Report of Examination for the March 2013 joint examination identified 4 transactions as apparent Section 23B violations, of which 3 transactions were previously identified as apparent violations in the October 2012 joint visitation. In each case the violation cited was the lack of contracts governing the particular transactions and failure to document the appropriateness of the fees paid by the Bank to its affiliate.

The Bank argues that there is no documentation requirement in the statutes, the Federal Reserve Board's Regulation W (12 C.F.R. Part 223), or in FDIC guidance, and that—since the Bank engages in no similar transactions with nonaffiliates — all that is required to comply with the "market terms" requirement of Section 23B is the Bank's good faith belief that the fees are on market terms.

The Committee is not persuaded by this argument. While the Bank is correct that Section 23B and its implementing regulations do not specify a record-keeping requirement, it is a tenet in safety and soundness regulation, and of an institution's own oversight responsibilities, that regulated entities must document their due diligence. For example, the Federal Reserve Board's Bank Holding Company Supervision Manual provides the following guidance on transactions subject to Section 23B: "The determination of fair market value or cost of providing services is the responsibility of the holding company. The examiner should *review the market or cost information used to justify the pricing* of services and be satisfied that the data presented actually supports the fee structure." (*BHC Supervision Manual*, section 2020.6.3 INSPECTION PROCEDURES (December 1993), (emphasis added.)) It is the regulated entity's obligation to perform due diligence to determine appropriate pricing, and examination for compliance requires reviewing the work that was done.

Similarly, in other contexts, examination requires review of a bank's documentation of its due diligence. Section 4.3 of the FDIC's *Risk Management Manual of Examination Policies* includes the following discussion of payments from subsidiary banks to their holding company parents (emphasis added):

> Although no formal policy statement has been issued by the FDIC, it has long been the FDIC's position that management and other fees paid by subsidiary banks should have a direct relationship to the value of actual goods or services rendered based on reasonable costs consistent with current market values for such services. *Bank files should contain adequate information to permit a determination as to what goods and services are being provided and on what basis they are being priced.*

Both examples are instances in which there is no separate, explicit requirement in the law to document the institution's due diligence, but supervision requires it. Significantly, without such documentation, an institution's own internal audit and oversight functions are impaired by an inability of the board to review the appropriateness of the transactions. Moreover, in this case, the Bank had notice of the need to document the basis for the fees paid for affiliate transactions. The Federal Reserve Bank of * * * explicitly included an instruction to do so in its September 25, 2012 letter to * * * and identified it as a matter requiring immediate attention. The FDIC's January 18, 2013 letter to the Bank identified the requirement as well, and highlighted it as a Section 23B issue. The Committee thus finds that the apparent Section 23B violations are well supported.

Compliance and IT issues

In its written submission and oral presentation, the Bank argues that the Compliance and IT issues identified in the Report of Examination for the March 2013 joint examination are each insufficient to justify a "4" rating for Management. The Division does not dispute this. The Committee notes that the Division has not suggested that these issues, taken individually, justify the Bank's ratings. The relevant question is whether the totality of the issues — compliance, IT, management oversight and audit functions, etc. — justify the ratings. For the reasons examined in more detail below, the Committee upholds the decision of the Director of RMS.

The Committee notes that the identified IT issues in particular could have posed a serious risk to the Bank. Among the issues cited was inadequate callback verification for wire transfers and inadequate risk monitoring for ACH transfers. These two issues expose the Bank to significant risk and contribute to both the Management and Composite Ratings at issue. Under the Uniform Rating System for Information Technology, a "3" rating indicates "some degree of supervisory concern due to a combination of weaknesses that may range from moderate to severe." As the Report of Examination for the March 2013 joint examination indicated, despite positive steps taken following the October 2012 visitation, the Board and management had failed to provide proper oversight and direction to the Bank's IT function, allowing IT and operational risk management practices to decline to unsatisfactory levels. In addition to the issues with wire transfers and ACH origination, weaknesses were identified in corporate governance and oversight, audit depth and follow up, and remote deposit capture. These issues justify the "3" rating for IT and support the Management rating as well.

The Management Component

The Uniform Financial Institutions Rating System ("UFIRS") provides the following guidance on the Management component rating:

> The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating…. Sound management practices are demonstrated by: active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the

> institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. The Management rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

A "3" rating "indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled." The Committee finds that the risks posed by the weak managerial oversight, the inadequate controls, and the contraventions of law and policy are too significant to warrant a "3" rating.

A "4" rating "indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary."

Serious management weaknesses were noted in the Report of Examination for the March 2013 joint examination. Even if the apparent Section 23B violations are ignored, the record demonstrates management deficiencies that expose the Bank to significant risk that required immediate action to correct. Here, as the Director found, the Report of Examination for the March 2013 joint examination documented significant weaknesses that include: conflicts of interest; violations of law; inadequate policies governing the Bank's Trust services; serious IT weaknesses; and failure to adequately address previously identified weaknesses.

At the time of the material supervisory determinations at issue, Board oversight was weak, and management failed to establish a proper control environment. Similar criticisms were noted at previous examinations. Related issues raised in previous examinations had not, at the time of the March 2013 joint examination, been adequately corrected. Of particular concern in past examinations were: (1) inadequate Board oversight over * * * expenses of * * *; and (2) lack of oversight over insider transactions resulting in $* * * million of unsecured credit extended to * * *. These lapses required immediate remedial action, sufficient to result in informal enforcement actions, yet the corrective actions that should have been completed before the March 2013 joint examination had yet to be fully implemented.

The management criticisms in the Report of Examination for the March 2013 joint examination are similar to criticisms levied at previous examinations. The Committee concludes that the Management component rating of "4" in the Report of Examination for the March 2013 joint examination is well supported.

Composite rating

The Bank argues that its Composite rating should be no lower than a "2," as it is a fundamentally sound bank that weathered the banking crisis in strong condition. RMS acknowledges that the factors that led to the "3" Composite rating are primarily the same factors discussed above, that led to the rating for management: repeat material violations of Section 23B, managerial and oversight deficiencies, less than satisfactory specialty exams, and lack of compliance with some provisions of its * * * MOU.

The Statement of Policy on UFIRS notes that the Composite rating generally bears a close relationship to the component ratings assigned, but is not an average of the ratings, and that some factors may receive special emphasis. Specifically, "some components may be given more weight than others depending on the situation at the institution….[and] the management component is given special consideration when assigning a composite rating." In order for a bank to receive a "2" rating, no factor should be below a "3." "Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3." This means that the well supported Management component rating, alone, would justify a "3" rating. In addition, the Composite rating reflects more than an institution's current financial performance, and reflects consideration of threats to the institution's long-term strength and stability.

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 a 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, and there are no material supervisory concerns.

An institution with a rating of "3" indicates 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" rated 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.

In this case, the record demonstrates that, during the time period relevant to the challenged material supervisory determinations, management lacked the ability or had been unwilling to address weaknesses that are sufficiently severe to warrant informal enforcement actions, identified over several examination cycles and visitations; and that risk management practices were less than satisfactory in relation to the institution's size, complexity, and risk profile. The

Committee affirms the Director's findings that the assigned component ratings accurately reflect the examination findings and that those findings support a Composite "3" rating.[4]

The Asserted Examiner Bias

In the Bank's written submission, it asserts that the "only reasonable explanation for the FDIC's imposition of a "4" Management rating is the personal bias and ill-will held by FDIC personnel towards the Bank...." During its oral presentation, the Bank played a recording inadvertently left on the Bank's voicemail system that the Bank purports demonstrates FDIC staff bias. RMS disagreed with the Bank on the identity of the parties in the recording, the subject of their discussion, and the significance of their discussion.

This Committee takes seriously accusations of examiner bias. However, the recording does not establish any procedural defect in the examination or demonstrate that the "4" Management component rating is not justified. The Committee affirms the Director's finding that there is no evidence that bias affected the material supervisory determinations in this case.

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 June 19, 2014.

[4] Although the Committee affirms the Director's findings with respect to the Composite rating for the March 2013 joint examination, it nonetheless wishes to acknowledge the Bank's actions, subsequent to the time of the disputed material supervisory determinations, to correct issues identified by examiners.