

**Decision of the  
Supervision Appeals Review Committee**

**In the Matter of \*\*\***

**Case No. 2018-07**

***I. Summary***

There are two aspects to this appeal. First, the appeal asks the Federal Deposit Insurance Corporation (“FDIC”) to consider how it fulfills its responsibility to preserve and promote the health of minority depository institutions (“MDIs”). The FDIC is undertaking a number of initiatives, as discussed in section IV below, regarding MDIs and, in particular, plans to revise its policy statement on MDIs to underscore the agency’s commitment to their well-being. The Supervision Appeals Review Committee (“Committee”) encourages \*\*\* (“Bank”) to participate in that effort. Because those policy issues exceed the purview of the Committee and merit broader consideration by the FDIC, they are outside the scope of this decision.

Second, the appeal challenges specific material supervisory determinations arising from an examination of the Bank that began on [date], 2017, and was conducted jointly by the FDIC’s \*\*\* [Region] and the [state regulator].<sup>1</sup> The Committee concludes that these determinations are supported by the record, are consistent with FDIC policies and practices, and were based on the information available at the time of the examination. Therefore, the Committee upholds the decision of the Director of the Division of Risk Management Supervision (“RMS”).

***II. Procedural History***

The [date], 2017 joint examination of the Bank resulted in CAMELS ratings of 324434/4.<sup>2</sup> The Report of Examination (“Report”) also noted matters requiring board attention with respect to interest rate risk, [certain] expenses, and [asset] concentration, as well as an apparent violation of Part 362 of the FDIC’s regulations.<sup>3</sup>

The Bank filed a request for review with the Director of RMS on June 16, 2018, contesting its assigned CAMELS ratings (except for the Asset Quality component rating) and the other

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<sup>1</sup> The [state regulator] concurred in the examination findings and assigned ratings.

<sup>2</sup> Capital “3,” Asset Quality “2,” Management “4,” Earnings “4,” Liquidity “3,” Sensitivity to Risk “4,” and Composite “4.”

<sup>3</sup> In addition, the Bank’s management of interest rate risk and [certain] expenses were cited as inconsistent with the safety and soundness standards described in Appendix A to Part 364 of the FDIC’s regulations.

supervisory determinations listed above. On August 2, 2018, the Division Director issued a decision upholding these determinations.

The Bank timely filed an appeal with the Committee by letter dated October 4, 2018. The appeal included an interest rate risk model that was not available at the time of the examination or at the time the Division Director had reviewed the matter. The Bank asserted that the model provided to the examiners had overstated the Bank's interest rate risk due to input and assumption errors, and requested that the Committee consider the updated model, which, according to the Bank, more accurately reflected the Bank's financial condition at the time of the examination. The Committee requested that the Division Director review the new information and supplement or revise her decision, as appropriate. On December 11, 2018, the Division Director issued a revised decision upholding the disputed determinations.

On February 21, 2019, the Bank filed a supplement to its appeal with the Committee, addressing the Division Director's revised decision. In accordance with the FDIC's *Guidelines for Appeals of Material Supervisory Determinations* ("Guidelines"),<sup>4</sup> the Committee has reviewed the appeal for consistency with 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 hear oral presentation from the parties on June 12, 2019.

### ***III. Discussion***

The Bank is transitioning its business model from a traditional margin-based banking to a fee-based model focused on \*\*\*. The Bank asserts that this approach will be less capital intensive and more profitable than traditional methods of client outreach and account creation. In the Committee's view, however, both the trend and level of the Bank's earnings were concerning at the time of the examination. Return on assets had declined substantially since [year], [turning negative at one point]. Moreover, the record reflects that the Bank had relied on gains from sales of securities or other assets to offset operational losses for several years. The reliance on asset sales did not appear to be sustainable, as the Report notes a reduction in the Bank's portfolio of available-for-sale securities and unrealized losses in the unencumbered portion of its portfolio. While fee income had increased significantly, this was offset by higher noninterest expenses.<sup>5</sup>

The record does not reflect sufficient action by the Bank's board of directors and management to address the Bank's financial condition. The Report states that at the time of the examination, most of the provisions of a [date] Memorandum of Understanding ("MOU") had not been

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<sup>4</sup> 82 Fed. Reg. 34,522 (July 25, 2017) (available at <http://www.fdic.gov/regulations/laws/sarc/sarcguidelines.html>).

<sup>5</sup> For example, deposit fee income increased about \$\*\*\* from the first quarter of 2016 to the first quarter of 2017, but the Bank's interchange expenses and data processing and marketing costs increased by about \$\*\*\* during the same timeframe. Report, p. 8.

satisfied, and the Bank continued to operate outside limits set by the board regarding interest rate risk. Overhead expenses steadily increased from \*\*\* percent of assets in 2015 to \*\*\* percent of assets in the first quarter of 2017, due partly to [certain] expenses that regularly exceeded approved budgets.<sup>6</sup> The Report acknowledges that management had taken actions to address performance. On balance, however, the record reflects that the Bank repeatedly was not operating within policy limits, underscoring apparent weaknesses in corporate governance.

The Report states that the Bank's capital ratios exceeded the well-capitalized thresholds at the time of the examination. However, an institution must maintain capital commensurate with its risk profile, notwithstanding minimum regulatory capital requirements.<sup>7</sup> The Committee finds that capital exceeding the minimum regulatory thresholds was warranted in this case, given the Bank's earnings performance, the uncertainty and expenses associated with its new business strategy, and its significant asset and funding concentration risks. Yet according to the Report, the Bank's Common Equity Tier 1 ratio exceeded the well-capitalized threshold by only \*\*\* basis points as of March 31, 2017.<sup>8</sup> Moreover, the Bank's capital ratios had declined from the prior examination without a corresponding reduction in the Bank's risk profile. The Committee concludes that the examiners' findings regarding capital are well-supported.

The examination findings with respect to interest rate risk also appear to be well-supported. The Bank's revised interest rate risk modeling indicates that risk had previously been overstated, but the failure to recognize or address errors in these models for several years suggests that the Bank's risk management practices required improvement. The Report states that the board and management had been operating outside internal policy limits for a number of years and had not satisfied the interest rate risk provisions of the MOU. The Report also notes that further reduction in income due to interest rate changes could result in significant deterioration in the Bank's condition, considering its weak earnings and less than satisfactory capital position given its risk profile.<sup>9</sup>

In addition, the record demonstrates the Bank's continued need to address funds management practices. The Report notes that the Bank relies heavily on [certain] wholesale funding \*\*\*. The Report states that about \$\*\*\* in \*\*\* deposits were maturing within one year, and the Bank's remaining \*\*\* borrowing capacity was insufficient to replace this funding. Furthermore, the

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<sup>6</sup> Report, p. 8.

<sup>7</sup> RMS Examination Manual § 2.1-7.

<sup>8</sup> In its appeal, the Bank asserts that more favorable risk weightings could have been used for certain \*\*\* loans, and its capital ratios were therefore understated by a range of \*\*\*% to \*\*\*%. The record does not include sufficient information for the Committee to assess this claim. As support for its assertion, the Bank refers only to discussions with examiners during a subsequent examination, and it does not appear that the relevant information was available during the [date], 2017 examination. In the Committee's view, however, even the revised capital ratios presented by the Bank would not warrant an improved capital rating, in light of the Bank's risk profile.

<sup>9</sup> See Report, pp. 5, 29.

Bank's funding action plan did not satisfy the provisions in the MOU, and projected reductions in wholesale funding were inconsistent with the board's Strategic Plan.

The Bank asserts that its ratings from the recent examination conducted by the FDIC's \*\*\* [Region] may be higher.<sup>10</sup> Under the *Guidelines*, however, the Committee's review is limited to the facts and circumstances as they existed prior to or at the time a material supervisory determination was made.<sup>11</sup> Based on the facts at the time of the 2017 examination, the Committee does not find sufficient grounds to overturn the Division Director's decision regarding the assigned ratings and the matters requiring board attention.<sup>12</sup>

#### ***IV. Supervisory Approach for MDIs***

The Bank [is an MDI]. In its appeal, the Bank asserts that the FDIC did not appropriately examine the Bank in light of section 308 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"),<sup>13</sup> which established a number of specific goals for federal regulators with respect to MDIs. Specifically, the Bank argues that because FIRREA requires the preservation and promotion of MDIs, a different examination and supervisory framework that reflects MDIs' unique challenges is warranted.

The FDIC has long recognized MDIs' unique importance in the financial system and has historically taken steps to preserve and encourage minority ownership of insured financial institutions. The FDIC's *Policy Statement Regarding Minority Depository Institutions* ("MDI Policy Statement") describes these measures, and serves as an important tool in ensuring that the agency's supervisory framework is aligned with the goals of preserving and promoting minority ownership.<sup>14</sup> To the extent changes or clarifications to the supervisory framework for MDIs may be warranted, those are best addressed through revisions to the MDI Policy Statement, rather than this Committee's decision. The Committee notes that the FDIC's efforts are intended to take into account the unique character and challenges of MDIs, which provide essential financial services to their communities, as well as that consistent application of safety and soundness standards promotes early identification and correction of serious problems, helping to preserve banks over the long run. Moreover, safety and soundness examinations are critical to the FDIC in fulfilling its congressional mandate to preserve and protect the Deposit Insurance Fund.

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<sup>10</sup> [The Bank was recently examined by another Region.]

<sup>11</sup> See *Guidelines*, section M.

<sup>12</sup> The Committee also finds no grounds for overturning the cited violation of Part 362. The Bank's appeal does not argue that the relevant investment was permissible; it simply states that the investment is being carried \*\*\* on the balance sheet and will be liquidated following the resolution of \*\*\*.

<sup>13</sup> Pub. L. 101-73 (Aug. 8, 1989); see also 12 U.S.C. § 1463 note.

<sup>14</sup> See 67 Fed. Reg. 18,618 (Apr. 16, 2002) (available at <https://www.fdic.gov/regulations/laws/rules/5000-2600.html>).

The FDIC plans to revise its MDI Policy Statement,<sup>15</sup> and the Committee encourages the Bank to participate in that effort. In addition, the FDIC will consider whether other supervisory activities or communications could further support its efforts to preserve and promote MDIs.

By direction of the Supervision Appeals Review Committee of the FDIC, dated August 8<sup>th</sup>, 2019.

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<sup>15</sup> See Statement of FDIC Chairman Jelena McWilliams before the House Committee on Financial Services, May 16, 2019.