Appeals Process

Appeal Summary 1—Certain Safety and Soundness Conclusions and Stay of Two Supervisory Directives

Background

A bank formally appealed certain conclusions contained in the most recent Report of Examination and asked for a stay of two supervisory directives. Specifically, the bank appealed the classification of certain loans, the adequacy of the allowance for loan and lease losses (ALLL), the adequacy of the bank's loan review process, and the composite rating, as well as, the component ratings of capital, management, and liquidity. Additionally, the appeal requested a stay of the revised capital plan directive and the directive to amend the most recent call report submission during the appeals process.

At the most recent examination, the supervisory office (SO) identified additional loan classifications and charge-offs as a result of poor credit underwriting and insufficient collateral values. The additional loan classifications and charge-offs required a substantial provision to the ALLL that severely affected earnings, liquidity, and capital. The SO further concluded that supervision by the board of directors and bank management was deficient because of vacancies in senior management positions, unproven new management, and previously identified weaknesses that remained unresolved. The SO also determined that the external loan review process was inadequate and lacked independence.

The appeal states that the bank disagreed with 56 percent of the loans classified by the SO and the corresponding reserve requirement. If the loan classification and reserve allocation were adjusted on those loans, the ALLL provision would be significantly reduced and capital and liquidity would be less strained. The appeal further stated that the ALLL, as calculated by the bank, was fully funded and adequate without any additional provision. Therefore, management did not agree with the methodology used by the examiners to calculate the adequacy of the ALLL. The appeal also reiterated the bank's position that the credentials of its external review firm are solid.

Discussion

Loan Classifications

For each of the loan classifications disputed by the bank, the ombudsman's office reviewed file documentation, line sheets, OCC write-ups, appeal comments, and loan review comments and held loan discussion. Our review found two loans criticized by the SO as "special mention" that could have been passed, however, there was no disagreement with loans classified as substandard, doubtful, or loss.

Allowance for Loan and Lease Losses (ALLL)

The ombudsman's office performed an in-depth review of the methodology used by both the bank and the SO to calculate the ALLL balance. Through our review of individual credits and loan discussion, however, we noted that the bank's specific allocations were not always consistent with the level of identified risk. The supervisory office approach included several methodologies and adjustments to industry averages that considered the weaknesses in loan underwriting, the uncertainty of lien positions, and the questionable collateral values identified by both the bank and the SO. This approach was consistent with the guidance in the *Comptroller's Handbook* booklet, "Allowance for Loan and Lease Losses" (June 1996).

Consideration was also given to how the bank's ALLL ratios compared to other 4- and 5-rated banks under $150 million in total assets. This bank had the highest level of classified assets among this peer group and the lowest coverage of ALLL to net losses. Additionally, it also had the lowest level of recoveries.

Loan Review Process

The ombudsman's office assessed the adequacy of the external loan review process by reviewing the services provided by the external loan review firm as well as the interaction with senior management of the bank. In addition to loan review, the external loan review firm provided a number of services to the bank including strategic planning, raising capital, and hiring of senior management. During our loan discussion with the bank, as well as in our face-to-face meeting, the external loan review firm actively participated in the defense of loan classifications and ALLL allocations. There is an appearance of a conflict of interest when the company that is assisting the bank in the solicitation of new capital is also responsible for identifying credit impairments and charge-offs that significantly affect the level of capital that the bank is attempting to raise. In addition, the external loan review, which was performed simultaneously with the SO exam, did not recognize a significant number of downgrades.

Composite and Component Ratings

Capital. Given that the loan classifications and the ALLL recommended balance were determined to be reasonable, the ombudsman concluded that the rating for capital was appropriate. There was a critical deficiency in the level of capital to absorb the high level of risk within the bank.

Management. At the time of the examination, the current management team was unproven, particularly given the significantly troubled condition of the bank. The most senior member of management had been in place less than six months, the presidency office was vacant, and new loan officers were hired during the examination. Notwithstanding the qualifications and experience of these individuals, the ombudsman concluded that the rating for management was appropriate.

Liquidity. The liquidity component was not reviewed as part of the most recent target examination. Therefore, the ombudsman did not opine on the rating that was carried forward from the previous full-scope examination.

Conclusion

The ombudsman granted the stay of the two supervisory directives during the appeals process. Accordingly, after conducting a review of the circumstances and facts present at the time in question, the ombudsman opined as follows:

- *Loan classifications*—The ombudsman found substantial integrity in the loan classifications assigned by the SO;
- *Adequacy of the ALLL*—The approach used by the SO to determine the adequacy of the ALLL was consistent with the guidance in the *Comptroller's Handbook* booklet, "Allowance for Loan and Lease Losses";
- *Loan review process*—The ombudsman concurred with the examination finding that the external loan review process was ineffective and lacked independence;
- *Component ratings*—The ratings assigned to management, capital, and earnings were upheld.
- *Composite rating*—Given the above conclusions, the ombudsman concurred with the examination findings that the bank exhibited an extremely unsafe and unsound condition. The volume and severity of problems, as well as the urgency to inject new capital jeopardized the viability of the bank. Therefore, the ombudsman concluded that the assigned composite rating was appropriate.

In addition to the findings above, the stays granted during the appeal process were lifted. The bank was directed to contact its SO to establish appropriate action and time frames.