Comptroller of the Currency
Administrator of National Banks

Report of the Ombudsman

"The Office of the Ombudsman remains steadfastly committed to the core principles of timely and fair dispute resolution and quality customer service."

December 2002

Mission and Objectives

Mission Statement

The Office of the Ombudsman is organized around core principles of dispute resolution and customer service. The office seeks to ensure national banks and customers of national banks receive fair and expeditious resolution of their complaints through two distinct units within the office. The National Bank Appeals Process is designed to resolve disputes of national banks arising from the supervisory process, while the Customer Assistance Group's primary focus is to ensure customers of national banks receive fair treatment resolving their complaints with national banks.

Guiding principles in fulfilling these responsibilities include:

- Maintenance of a professional staff.
- An environment that disadvantages no one and embraces a sense of fairness.
- Independence and no retribution.
- Convenience and accessibility for constituents.
- Effective use of technology.
- Processes that incorporate the OCC's regulatory responsibility.
- Confidentiality.

Objectives

- Continue to support agency objectives and provide value to OCC's mission.
- Deliver quality customer service that serves all constituents' interests and contributes to the effective supervision of the national banking system.
- Gather and analyze data and distribute meaningful information to our constituents.
- Formalize processes that will enable the ombudsman's leadership team to guide the creation of strategies, systems, and methods for achieving excellence and building capabilities.
- Create a work environment conducive to performance excellence, full participation, and personal and organizational growth.
- Establish an effective work process infrastructure that leverages technology to carry out the ombudsman's mission.

Report of the Ombudsman

Office of the Comptroller of the Currency
Washington, D.C.
December 2002

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MESSAGE FROM THE OMBUDSMAN

The financial services industry and our nation's economy have experienced significant changes. The landscape of regulatory supervision continues to evolve in response to financial legislation reform, industry consolidation, the emergence of an array of non-traditional products and services, and the impact of competitive pressures on credit quality. The tragic events of September 11, 2001, spawned additional challenges for the entire financial services industry. The manner in which national bankers navigated through these unprecedented circumstances is a testimony to their resolve, focus, and contingency planning efforts. As I reflect on these issues and contemplate future challenges, I recognize that the role we serve in the Office of the Ombudsman must also evolve to effectively satisfy the changing needs of our varied constituents.

While much has transpired since issuance of our last *Report of the Ombudsman,* the principles that enable the OCC to successfully fulfill its mission remain unchanged. The Office of the Ombudsman remains steadfastly committed to the core principles of timely and fair dispute resolution and quality customer service. We have incorporated these principles into our strategic management plan. This plan integrates strategic planning efforts into our daily activities and includes a process that monitors and measures our progress, accomplishments, and level of service.

The National Bank Appeals Process, the Examination Questionnaire, and the Customer Assistance Group (CAG) remain the primary vehicles we use as catalysts for improvement in the industry and the agency. This report contains summaries of the formal appeal decisions rendered during this time period. It also contains an analysis of the examination questionnaires submitted by bankers at the conclusion of their on-site examination over the last 12 months. Finally, the report includes an analysis of the broad array of dynamic issues that emerged from the work of our Customer Assistance Group, including our impact on each of its constituents. We offer these as components of the value added by this office to the OCC's ongoing effort to enhance the effectiveness of supervision of the national banking industry.

I firmly believe that the most effective method of resolving disputes is for all parties to work through their disagreements. Although highlighted in prior reports, it merits reemphasizing that the Office of the Ombudsman was established to provide a method to resolve disputes that persist despite efforts to handle them at the operational level. The OCC is unique in that the ombudsman has decision-making authority to resolve appeals and functions similar to a binding arbitrator. While the OCC ombudsman has decision-making authority to resolve appeals, we often facilitate resolution through practical means such as involving the appropriate decision-makers, technical experts, or simply by remaining engaged with both parties as they work through the underlying issues.

The OCC's National Bank Appeals Process was modified through the issuance of OCC Bulletin 2002–9, dated February 25, 2002. Modifications were made to enhance the clarity of the process and to create brighter lines on what and when issues are appealable. The revised process now provides a venue that allows bankers to appeal supervisory decisions and determinations that result in informal enforcement actions. The other noteworthy change to the process is clarification of the term "enforcement-related decisions." The revised bulletin reflects OCC's continued commitment to provide an appellate process that is independent, empowered, and dedicated to providing a venue where bankers can comfortably challenge supervisory determinations without fear of reprisal. A copy of OCC Bulletin 2002–9 and the frequently asked questions are included in the appendix of this report.

Administration of the OCC's examination questionnaire by the ombudsman provides independence and confidentiality, alleviating bankers' concerns over retribution. Use of the questionnaire permits us to gather direct and timely feedback from bankers, which is then used to measure and improve the effectiveness of the supervisory process. The examination questionnaire further demonstrates the OCC's commitment to improve quality bank supervision.

The Customer Assistance Group acts as a liaison between national banks and their customers; however, it is not an advocate for either party. Our non-biased assistance with problem resolution is beneficial to all concerned, and reflects OCC's commitment to ensure fair access to financial services and fair treatment for all national bank customers. CAG continues to provide identified complaint trends and consumer issues through detailed reports, on-site meetings with bankers, and direct consultation with OCC's supervision staff. Information identified from the complaints serves as an early warning system for potential areas of risk.

Consistent with our mission to provide high quality customer service and our commitment to use technology to enhance our effectiveness and efficiency, the OCC developed CAGNet. This is a Web-based "business-to-business" application that facilitates the paperless transfer of consumer complaints, the banks' responses, and analytical reports via a secure and dedicated extranet application. In addition to improving complaint resolution time, CAGNet has decreased the administrative burden for both the industry and the OCC. To date, CAGNet has been made available to the population of banks that generate the highest customer complaint volumes. A similar Web-based application was developed that provides read-only access into our complaints database to our OCC internal constituents.

Lastly, I am committed to my focus on people within and outside the OCC. As I look to the future, I remain committed to satisfying the needs of our constituents. I encourage you to solicit the services of the Office of the Ombudsman when needed.

Samuel P. Golden
Ombudsman

THE NATIONAL BANK APPEALS PROCESS

Comptroller of the Currency Eugene A. Ludwig established the National Bank Appeals Process in June 1993. The effectiveness of the Office of the Comptroller of the Currency's (OCC's) process contributed to a congressional mandate that all federal banking agencies establish their own appeals processes. In September 1994, President Clinton signed into law section 309(a) of the Regulatory Improvement Act of 1994, which contains that requirement.

The OCC Bulletin 2002–9, "National Bank Appeals Process" (revised and reissued) February 25, 2002), describes the OCC's policy regarding its appeal process. See the appendix to this report for a copy of this bulletin.

How To File An Appeal

The OCC established the National Bank Appeals Process for the express purpose of providing an independent, alternate avenue for handling matters on which reasonable people disagree. The availability of an appeals process to the Office of the Ombudsman not only benefits the individual bank filing the appeal, but also provides systemic benefits to all national banks and the OCC by bringing issues to the attention of the agency.

If a national bank and the supervisory office cannot resolve a disagreement arising out of the supervisory process through informal discussions, the OCC encourages national banks to seek a further review of the OCC decision or actions that are in dispute through the National Bank Appeals Process. The ombudsman has authority, with the prior consent of the Comptroller, to stay any appealable agency decision or action in the resolution of an appealable matter. Except as otherwise provided below, a national bank may seek review of *any* agency decision or action, including (1) examination ratings (2) adequacy of loan loss reserve provisions, and (3) classifications of loans that are significant to an institution. A national bank may not appeal to the ombudsman or its immediate OCC supervisory office:

1) Appointment of receivers and conservators;

2) Preliminary examination conclusions;

3) Any formal enforcement-related actions or decisions, including decisions to (a) seek issuance of a formal agreement or cease-and-desist order, or the assessment of a civil money penalty; (b) take prompt corrective action; (c) issue a safety and soundness order; and (d) commence formal investigations;

4) Formal and informal rulemakings;

5) Decisions or recommended decision following formal and informal adjudications;

6) Freedom of Information Act (FOIA) requests;

7) Decisions made to disapprove directors and senior executive officers pursuant to Section 914 of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA); and

8) Any other agency decisions that are subject to judicial review.

A national bank may seek review of appealable matters by filing an appeal with *either* the ombudsman or the bank's immediate supervisory office. The bank should submit information in writing fully describing the matter(s) in dispute. In the absence of any extenuating circumstances, the OCC official will issue a written response to the appeal within 45 calendar days of accepting an appeal. If a bank files the appeal with its immediate supervisory office and it disagrees with the decision rendered, it may further appeal the matter to the ombudsman.

If you would like more information about the National Bank Appeals Process, or would like to discuss an agency or action, contact Samuel P. Golden at:

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RESULTS OF THE EXAMINATION QUESTIONNAIRE

(JANUARY–DECEMBER 2001)

Background

The OCC is committed to providing quality bank supervision to all financial institutions subject to its regulatory authority. This commitment is built into OCC's mission statement and carried out through the agency's establishment of annual objectives. The development of effectiveness measures has been an OCC priority objective. One of the tools used by the OCC to measure the effectiveness of the supervisory process is the examination questionnaire, which is attached to each report of examination. This questionnaire is designed to gather direct and timely feedback from bankers on OCC's supervisory efforts.

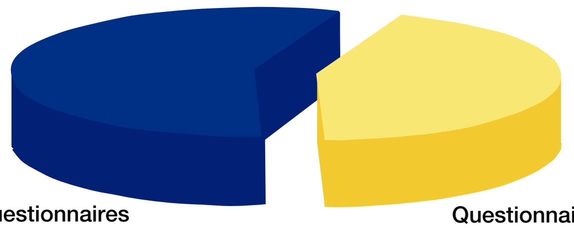
To assure bankers of OCC's interest in frank comments, the administration of this entire process is assigned to the Office of the Ombudsman. By providing complete independence and confidentiality, this assignment alleviates bankers' concerns over retaliation or retribution. This also reassures examiners that the questionnaires will not be used in performance management. The information received from these questionnaires provides OCC management with an indication of its overall effectiveness, and also allows the OCC to refine and enhance the quality of supervisory efforts.

While there is comfort in the overall positive tone of the responses, constructive feedback was also given that enables the agency to refine and further enhance the quality of our supervisory efforts. The ombudsman or the assistants to the ombudsman review each questionnaire. Based on the comments received from the individual respondents, a decision is made on whether further contact with the banker is warranted. During the most recent 12-month period, roughly 16 percent of the respondents were contacted for clarification, additional details, or follow-up. Confidentiality is a core element of this entire process. Copies of the questionnaires are not available to anyone outside of the Office of the Ombudsman.

Response Rate

Semi-annually, the ombudsman's office compares the number of reports of examinations (ROEs) mailed to banks with the number of questionnaires received to track the response rate. Because questionnaires, in general, are not viewed positively, response rates usually are low. However the response rate to OCC's questionnaire has been good. For the 12-month period between January 1 and December 31, 2001, the agency mailed 1,884 questionnaires and the ombudsman's office received 832 questionnaires. As shown in Figure 1 this is a response rate of 44 percent.

Figure 1—Percent of Questionnaires Returned



Additionally, a significant number of respondents also provided detailed narrative comments to accompany the completed questionnaires. Approximately 55 percent of the respondents provided narrative comments to further clarify their responses. While the confidentiality of the respondent is maintained, we analyze comment trends.

Results and Recommendations

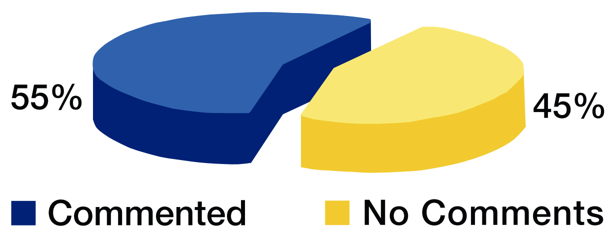
Feedback on the most recent examination as well as the effectiveness of OCC's overall supervision process during the past 12 to 18 months was solicited through the questionnaire process. The questionnaire asks respondents to rate the OCC on 22 questions relating to the professionalism and responsiveness of examiners, the reasonableness of the examination scope, and the appropriateness and clarity of the exam conclusions. Additionally, there are four narrative questions that ask for more detail on the examination just completed. Two ask for the most and least useful aspects of the OCC's supervision process. The remaining two ask for areas where examiners need greater knowledge, and areas where the OCC's fundamental supervision approach and/or methods of supervision need to change.

Bankers nationwide continue to give the OCC favorable ratings, as demonstrated in Table 1. The average rating on all 22 numerical questions in the aggregate over the past three years is a stable 1.50. The most favorable rating continues to be on question #3, dealing with the professionalism of the examination team. This outcome is not a surprise, as professionalism is continually stressed to examiners and its criteria are more removed from the condition and complexity of a particular bank. The least favorable ratings were received on question 19c, which asks whether OCC regulation eliminates unnecessary regulatory requirements and minimizes the burden resulting from requirements necessary for effective supervision. Bankers often associate this question with various legislative initiatives rather than the burden of the regulation.

Narrative question 1—Most useful aspect of the OCC's supervision:

During the last 12 months 55 percent of the bankers responded to this question, as shown in Figure 2a. The most frequent comments related to the benefit of receiving feedback, suggestions, and answers to questions from the on-site examination followed by comments on the demeanor and/or skills and knowledge of examiners. The frequency of these comments may provide support for question #3's continued status of most favorable rating (the examination team conducted the examination in a professional manner).

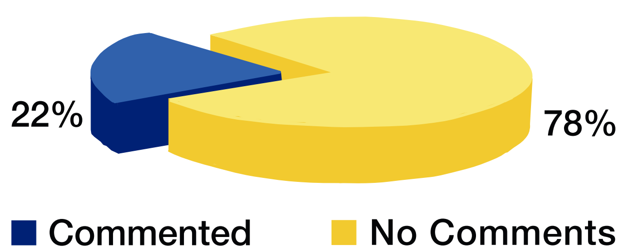
Figure 2a—Most Useful Aspects of the Examination



Narrative question 2—Least useful aspect of OCC's supervision:

During the last 12 months 22 percent of the bankers responded to this question, as shown in Figure 2b. Community Reinvestment Act (CRA) compliance received the most comments. Concerns on insignificant and regulatory issues and examiner approach all equally followed as the second most cited comment.

Figure 2b—Least Useful Aspects of the Examination



Narrative 3—Areas where bankers think OCC examiners need greater knowledge:

Twenty-one percent of the bankers offered comments to this question. The most frequent comment received offered no suggestions, but stated they were satisfied with current OCC knowledge. The second most frequent comment suggested greater knowledge in technology and Internet banking was needed. The majority of comments from bankers on technology state that examiners and bankers both need to stay abreast of technological changes.

Narrative 4—Areas where OCC's supervisory approach needs enhancement:

Responses to this question were broad in nature. The highest number of comments indicated that bankers were satisfied with OCC's current approach. Inconsistent requirements of large versus small banks and the need to concentrate on asset quality/lending followed as the second most cited comment.

Table 1—Questionnaire Results: Bankers' Ratings of OCC Examinations for January 1, 1999 through December 31, 2001

Questions	Results: 1999	Results: 2000	Results: 2001	Three-year Average
1. The examination scope was appropriate to accurately assess the bank's condition.	1.40	1.42	1.36	1.39
2. The examiners' requests for information before and during the examination were reasonable and justified by the examination scope.	1.32	1.36	1.35	1.34
3. The examination team conducted the examination in a professional manner.	1.22	1.22	1.21	1.22
4. The examination placed appropriate reliance on the internal audit function and internal risk management functions in the institution to support effective supervision.	1.47	1.47	1.43	1.46
5. The examiner-in-charge and the examination team were knowledgeable.	1.29	1.31	1.27	1.29
6. The examiner-in-charge and examination team provided useful feedback, observations and suggestions.	1.38	1.37	1.36	1.37
7. The examiner-in-charge and examination team presented well-supported relevant conclusions regarding the condition of the bank.	1.49	1.47	1.47	1.47
8. The recommendations for corrective actions made by the examiner-in-charge and the examination team were reasonable.	1.49	1.49	1.50	1.49
9. During the exit and board meetings, the examiner-in-charge and examination team clearly and effectively communicated their findings and concerns.	1.31	1.30	1.32	1.31
10. The tone and content of the report of examination were consistent with the exit and board meetings.	1.27	1.28	1.26	1.27
11. The report of examination clearly communicated examination findings, significant issues and the corrective actions (including time frames) management and/or the board needed to take.	1.31	1.32	1.30	1.31
12. On-going communication by the examiner-in-charge with senior management and the board of directors was appropriate.	1.30	1.29	1.29	1.29
13. Examiners minimized the burden to the degree possible on the bank, its officers and employees when conducting the examination.	1.40	1.42	1.44	1.42

14. The supervisory objectives and strategy incorporated appropriate perspective and provided necessary focus on business risks, assessment of their significance, and resulted in appropriate development of the examination strategy, emphasis on key risk areas, and resulting areas of focus in the examination.	1.52	1.52	1.52	1.52
15. The examination report was delivered in a timely manner, so examination results and corrective actions required by bank management were influenced in a timely and appropriate manner.	1.34	1.36	1.41	1.37
16. During the past year or 18 months (i.e., the examination cycle), OCC_________________has/have been responsive to the bank's needs.				
16. a) field staff;	1.28	1.28	1.28	1.28
16. b) corporate staff (e.g., for corporate applications);	1.38	1.35	1.33	1.37
16. c) attorneys (e.g., for legal opinions);	1.52	1.60	1.62	1.61
16. d) accountants (e.g., for accounting opinions);	1.45	1.50	1.52	1.51
16. e) other	1.38	1.33	1.57	1.50
17. The OCC identifies potential problems before they can cause significant harm to the bank.	1.83	1.81	1.81	1.82
18. The OCC's supervisory efforts focus on banking activities that pose the highest risk.	1.63	1.64	1.62	1.63
19. OCC regulations:				
19. a) effectively target the areas of bank activity that present the greatest risk to safety and soundness, the payments system, or the long-term viability of the national banking system.	1.73	1.78	1.73	1.75
19. b) promote national banks' competitiveness and allow industry innovation;	2.15	2.09	2.08	2.11
19. c) eliminate unnecessary regulatory requirements and minimize the burden resulting from requirements necessary for effective supervision.	2.41	2.34	2.36	2.37
20. The OCC works with the bank and follows-up to ensure bank management addresses potential problems and risks	1.41	1.41	1.44	1.42
21. The OCC allows the bank to offer new products and services if the bank has the expertise to manage the risks effectively and to provide the necessary consumer protections	1.61	1.58	1.54	1.58
22. The OCC enforces CRA and fair lending laws by focusing on the bank's performance.	1.77	1.73	1.71	1.74
Average Rating	1.50	1.50	1.50	1.50
Number of Questionnaires	958	903	832	2,693

CUSTOMER ASSISTANCE GROUP

Introduction

In June 1997, the ombudsman assumed responsibility for managing the agency's consumer complaint function. The function was re-engineered to address the changing needs of today's national bank customers and was centralized in Houston, Texas. In April 1998, the renamed Customer Assistance Group (CAG) opened and began full operation with a staff of compliance professionals and modern call-center technology.

As a regulatory agency, the OCC is responsible for ensuring the safety and soundness of the national banking system. By facilitating communications between national banks and their customers, the CAG supports industry efforts to sustain a broad and satisfied customer base in a highly competitive financial services market.

The CAG's constituents include:

- Customers of national banks,
- Management of national banks and,
- OCC's bank supervision staff.

The CAG operation is continuously being enhanced to employ the best practices of today's most successful call centers. The incorporation of a Web-based complaint resolution process (CAGNet), a quality assurance program, and 24 hour, 365 days a year Internet access, are some of the initiatives that have refined the CAG's ability to deliver responsive customer service. CAG specialists provide callers with current information on banking regulations while maintaining the philosophy of resolving as many cases as possible at the point of first contact. In addition, CAG specialists are able to handle cases in languages other than English.

The results of CAG's improved operation in the past several years demonstrate a consistent ability to deliver quality service to each of our constituents.

New Initiatives

CAGNet

Developed during the fourth quarter of 2000 and fully implemented during 2001, CAGNet is a Web-based application created to help speed complaint resolution time and increase efficiency for both the banks and the CAG. Through the CAGNet application, the consumer's complaint data is electronically delivered from the CAG to bank management for response. Likewise, bank management electronically submits a documented response to the CAG for review. Additionally, bank management has access to their current and historical complaint data through a standard set of reports. Currently, 22 banking companies are using this business-to-business application to respond to written customer complaints.

Quality Assurance Program

A quality assurance program was established to provide a documented measure of the level of service delivered to customers by the CAG. Quality standards have been established to ensure the effectiveness of the consumer complaint process. During 2000, a voice recording system was incorporated to monitor calls handled by specialists to ensure performance standards are being met and to identify improvement opportunities.

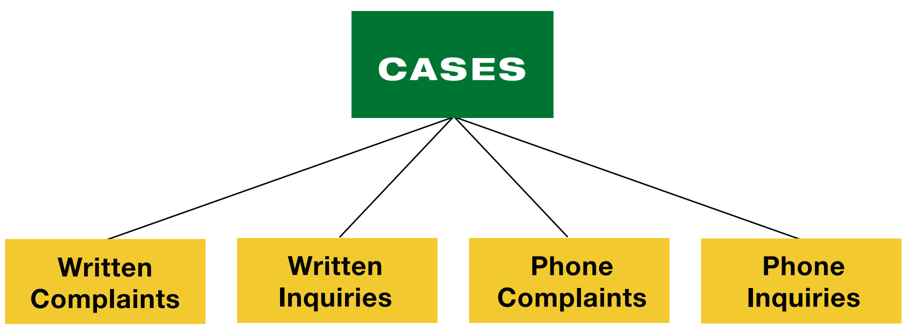
Internet Access

Through a single Web address—www.occ.treas.gov—customers of national banks can access valuable information about the OCC including, the complaint resolution process, ways to contact a customer assistance specialist and available help from other federal agencies. This 24-hour, 7 days a week service is another venue to help facilitate the resolution of consumer inquiries and complaints.

Case Volumes

The CAG continues to receive a steady stream of cases via telephone calls, e-mail, and written correspondence. The CAG uses the term "case" to track written, e-mail, and telephone complaints and inquiries. A complaint is defined as an expression of dissatisfaction about a national bank. An inquiry is defined as a question or comment about a national bank or federal laws and regulations related to banking. Figure 3 shows the relationship.

Figure 3—Customer Assistance Group cases



The 50–55 percent of complaint calls that cannot be resolved immediately on the telephone, along with any written complaints received, are sent to the processing unit for research and bank contact.

Figures 4a and 4b below illustrate the call and case volumes for 2000, 2001 and 2002.

Figure 4a—Customer Assistance Group incoming call volumes

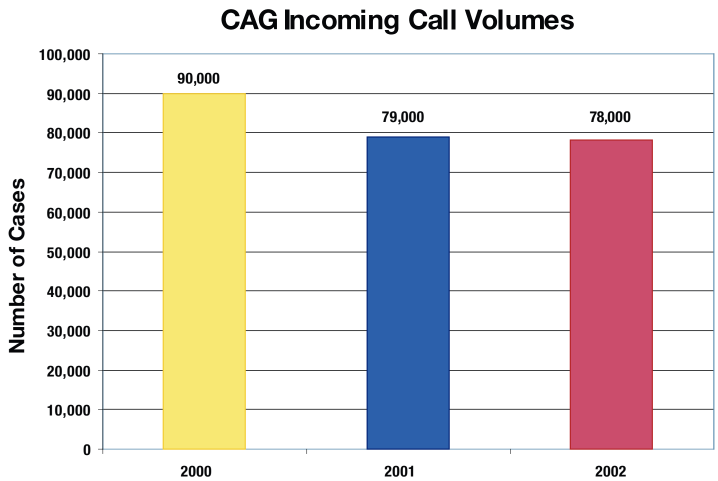
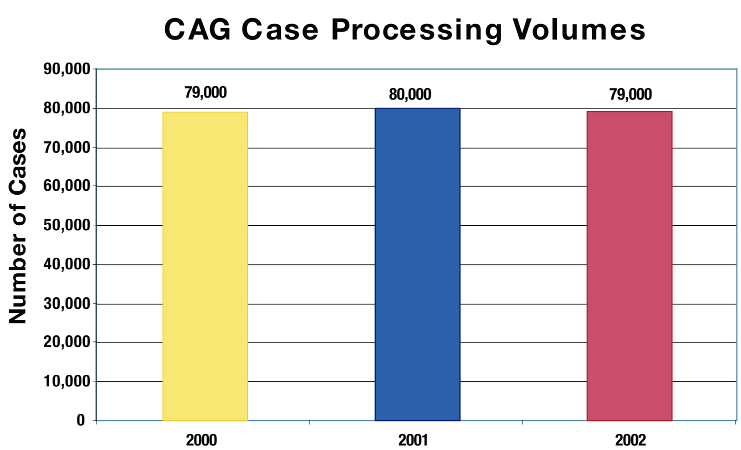


Figure 4b—Customer Assistance Group case processing volumes



Summary of Activity

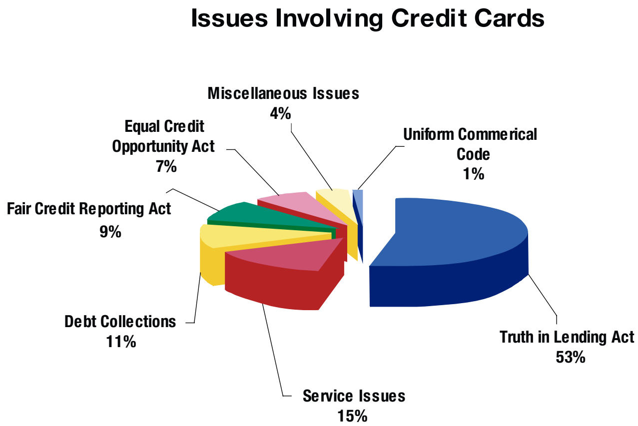
Customer concerns through 2002 reflect the same trends as the past years, focusing primarily on loan and deposit accounts. Credit card and checking accounts remain the highest source of consumer complaints. Additional areas of consumer complaints include: home mortgages, non-deposit investments, insurance products, and asset management, along with a broad spectrum of other bank products and services.

Credit Cards

Credit cards remain the number one source of complaints, representing more than a third of all complaints brought to the CAG, as shown in Figure 5.

Truth in Lending Act concerns and customer service issues continue to be the primary focus of credit card complaints. Other complaints include the Fair Credit Reporting Act, debt collection practices, and the Equal Credit Opportunity Act.

Figure 5—Issues involving credit cards (as of 12/31/02)



Truth in Lending Act

The Truth in Lending Act (TILA) contains error-resolution provisions that cover billing error disputes, unauthorized use, legal claims, and actions a customer may employ in defense of a disputed charge. Billing error disputes are the most common complaint for credit card account holders. Credit card customers often misunderstand the dispute provisions of the TILA. Bank customers commonly believe they have blanket protection when using a credit card and can apply a “stop payment” on charges. Through the complaint process, the CAG attempts to educate consumers on the dispute provisions of TILA.

Another common complaint involves changes in terms to credit card agreements, as consumers often believe they are protected from changes. In addition, bank disclosures of changes in terms are often written in small print and frequently included among the advertising materials that accompany credit card statements. However, contract terms can be modified because of changes in bank policy or when banks transfer their credit card portfolios through sales, mergers, or acquisitions. Among other things, interest rates may be raised, fees added, grace periods eliminated, or policies on late payments tightened. The CAG regularly provides consumers with guidance as it relates to understanding their rights contained in TILA and other consumer banking regulations.

In addition to the provisions contained in TILA, the CAG reviews bank practices related to advertising, bait-and-switch techniques and misleading claims about costs of services provided or failure to provide services after fees have been paid. Should patterns or practices be disclosed, CAG will refer the complaints to the appropriate OCC supervisory office to review for possible unfair or deceptive acts or practices under section 5 of the Federal Trade Commission Act, 15 USC 45(a)(1).

Loan Product Customer Service Issues

Customer service issues represent a broad category that captures customer dissatisfaction with bank products, services, or communication with bank employees. These issues may be related to regulatory concerns, but do not fall under specific regulations. Some examples of customer service issues are:

- Increased fees and/or higher interest rates without any perceived additional benefits,
- Dissatisfaction with the ability of bank employees to clearly explain bank products, services, or customer rights and,
- Right to privacy.

The CAG works with both the banks and its customers to provide consumers with guidance and education on these and other issues.

Fair Credit Reporting Act/Debt Collection

Fair Credit Reporting Act issues typically arise after a customer has approached the credit bureau regarding a bank's reporting of account information. The consumer believes the information is incorrect and the CAG facilitates a review at the bank to ensure the credit report is accurate.

Debt collection issues often involve complaints about the conduct of collection agents employed by the bank. A bank customer may also assert that the account was placed in collection in error. The CAG facilitates an evaluation by the bank to ensure collection practices are within permissible guidelines or that the account has been properly referred for collection.

Illegal Discrimination

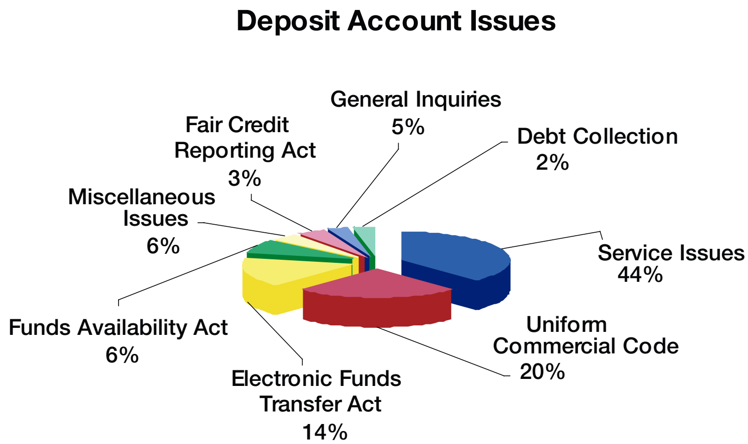
Many complaints involving the Equal Credit Opportunity Act (ECOA) and Fair Housing Act (FHA) result from reasons provided to customers by the bank when declining a credit application. Standardized declination letters do not always provide customers with a clear understanding of the bank's reasons for credit denial. In other cases, customers misunderstand their protections under ECOA. When the basic provisions of ECOA and FHA are explained to them by CAG staff or provided to them in writing, customers often realize their rights have not been violated.

The CAG considers every complaint alleging illegal discrimination seriously. If the CAG has reason to believe that illegal discrimination may have occurred, its staff will notify the OCC division responsible for fair lending issues.

Deposit Accounts

Customer concerns about deposit accounts center on customer service, Uniform Commercial Code, and Electronic Funds Transfer Act issues, as is shown in Figure 6.

Figure 6—Deposit account issues (as of 12/31/02)



Deposit Product Customer Service Issues

The primary customer service issues represent bank customer dissatisfaction with fees and charges, systems/technology, and communications. Examples include:

- Fees and charges where there is no regulation on the nature and amount of fees that banks charge their customers. One of the most common issues is an increase in or imposition of additional fees (such as fees for check cashing and presentment of checks against insufficient funds).
- Systems and technology issues involving ATM failures, lost/misplaced deposits, or processing problems with on-line banking.
- Dissatisfaction with bank employees' explanations of bank products, service fees, or customer rights. Employees often restate bank policy without providing clarification of policy and its implementation. The result can be ineffective communication between customers and bank employees.

The remaining service issues involve customer privacy; bank employee knowledge about terms, products, and services offered; access to bank premises or products; and other inquiries concerning checking accounts. The CAG's resolution to all deposit customer service issues or complaints typically involves explaining to the consumer their rights, and the banks' rights, practices, and privileges.

Uniform Commercial Code

The Uniform Commercial Code (UCC) covers the negotiation and collection of checks and drafts involving commercial transactions along with sales contracts and agreements. Disputes over UCC issues are primarily contractual issues between the bank and its customers. Lost and forged instruments, contractual issues, and stop-payment procedures are the most common transactions that initiate consumer calls. Many bank customers are not familiar with their rights under the UCC. Complaints and disputes under this area are frequently related to miscommunication or lack of assistance provided to the consumer. While the CAG generally does not intervene in UCC issues in some instances, customers are advised to seek legal assistance to facilitate the resolution of this type of complaint.

Electronic Funds Transfer Act

Consumer concerns with the Electronic Funds Transfer Act (EFTA) primarily involve unauthorized transfers and error resolution issues. The regulation requires consumers to promptly notify the bank of any unauthorized use of the card, but does not address the extent of investigation the bank should conduct once notified. Consumers are often dissatisfied with the banks' efforts to resolve the disputed transaction. In most cases, the OCC facilitates communication with the banks to ensure an expeditious and satisfactory investigation process takes place.

In the fourth quarter of 2001, the OCC issued an Advisory Letter (AL 2001–9) that reminds bank management of their obligations under the EFTA and Regulation E. The OCC wishes to ensure that banks fully comply with the EFTA's error resolution requirements and that they conduct adequate investigations of claims of unauthorized transactions.

Some Lessons Learned

The increased complexity of banking laws, regulations, and practices has resulted in a heightened level of consumer concerns. Bank sensitivity to customer concerns is increasingly important and can have an impact on a bank's position in a competitive marketplace. Through CAG's experience, some of the lessons learned are as follows:

- Complaints serve as an opportunity for banks to detect and correct potential and existing problems, resulting in a more effective management of compliance, operations, and reputation risks.
- Banks benefit from customer loyalty and favorable marketplace reputation when they keep their customers informed beyond the minimum regulatory requirements.
- Customer misconceptions persist even when they have received all required disclosures. Misconceptions can often be minimized if bank employees are able to provide a clear explanation of disclosures and corresponding rules, when customers express confusion.
- Performing a reasonable investigation of the consumer's concern initially could minimize the volume of complaints to the CAG. Banks are reminded to make a good-faith attempt to evaluate all facts and circumstances of a customer's complaint.

- The empowerment of bank employees to efficiently resolve customer concerns at the lowest practical level can increase satisfaction and loyalty. The dollar amount in dispute is often lower than the cost of processing a bank customer complaint.
- The type and nature of the bank's primary business line and its business practices are better indicators of potential case volume than bank asset size.

Service to Others

For decades, national banks have cooperated with the OCC to resolve customer concerns. This benefits financial institutions, consumers, and the OCC

Industry Partnerships

The CAG helps facilitate regulatory compliance and provides information to help national banks strengthen their risk management systems. To accomplish this, the group conducts formal and informal meetings or discussions with bank representatives and generates reports for individual institutions that identify complaint trends and consumer issues. Information provided by the CAG can serve as an early identification warning system for potential problems.

Educational Partnerships

The CAG facilitates communication between the bank and its customers in the resolution of individual cases. Customers receive information and education on banking practices and laws. Through the customer assistance process, the CAG gains insight about standard bank products such as loans and deposits, and obtains information about a broad spectrum of other financial products and services offered by national banks and their affiliates. This information provides insight into specific issues arising from account transactions, banking practices, and issues that may affect risk management. The CAG also provides banks with information gleaned from the process, to enable them to respond internally to issues that shape bank customer satisfaction.

Supervisory Partnerships

The CAG develops and maintains ongoing dialogue with the OCC's bank supervision staff. The CAG also compiles and analyzes data and prepares internal reports for the OCC's bank supervision staff that gives information on volume, trends, and categories of customer cases. Through this process, the CAG identifies risk management issues and potential violations of law that may be included in the examination strategy. In an effort to prevent systemic replication of problems identified in individual institutions, the CAG routinely discusses "Hot topic" consumer issues with bank supervision personnel.

APPENDIXES

APPENDIX 1—APPEAL SUMMARIES

An appeal summary is prepared for each formal appeal received in the ombudsman's office. These summaries serve to help share the systemic benefits gained from the formal appeals. The appeal summary gives the basic facts of the formal appeal without identifying the appealing institution. Each summary has a background, discussion, and conclusion section and describes the basic issues being appealed.

This section includes the appeal summaries for the formal appeals resolved during the past 30 months. These are summaries of eight CRA ratings, 10 Miscellaneous Safety and Soundness issues, 10 composite CAMELS ratings, five violations of law, and one accounting issue. All of these appeal summaries have been published in the OCC's *Quarterly Journal*.

CRA Ratings

Appeal of "Satisfactory" CRA Rating

Background

A large retail bank filed an appeal concerning its Community Reinvestment Act (CRA) rating of "Satisfactory." The bank also appealed the lending test rating of "High Satisfactory," the investment test rating of "Low Satisfactory," and the service test rating of "High Satisfactory." The bank's last Public Evaluation (PE) rated the bank as having an "Outstanding Record of Helping to Meet the Community Credit Needs."

The submission noted that even prior to the enactment of CRA, the bank took great pride in delivering its products and services to all individuals and businesses in its trade area. It continued that since the inception of CRA and the rating system, the bank had made every effort to attain and sustain an "Outstanding" CRA rating. CRA has become a part of the bank's yearly business plans and a major goal of the bank's management. The submission detailed the reasons for disagreement on each of the tests and the overall rating, as follows:

The PE states that the primary reasons for the bank being rated "Satisfactory Record of Meeting Community Credit Needs" are:

- The bank's lending levels reflect a good responsiveness to the credit needs of its assessment area.
- A substantial majority of the bank's loans are in the assessment area.
- The bank's distribution of small loans to businesses is good. The bank's geographic distribution of small loans to businesses is also good.
- The bank has a good distribution of loans to borrowers of different income levels. The bank's geographic distribution of loans to borrowers of different income levels is satisfactory.
- The level of community development investments and grants is adequate. However, the bank makes extensive use of flexible lending programs to help meet the needs of its assessment area (AA).

- The bank's delivery systems are accessible to geographies and individuals of different income levels. To the extent changes have been made, the bank has improved the accessibility of its delivery systems.
- The institution provides a satisfactory level of community development services.

The bank is an intrastate bank and is the lead bank in a multi-bank holding company. The bank's assets exceed $2 billion with multiple offices located in four counties. Ninety-five percent of the offices are full-service locations. The bank owns and operates a number of automated teller machines (ATMs) in its assessment area (AA). The bank's AA consists of two separate but contiguous areas. One of the bank's AAs is a metropolitan statistical area (MSA), while the other is a non-MSA. The bank's AAs are comprised of 2 percent low-income geographies, 22 percent moderate-income geographies, 61 percent middle-income geographies, and 9 percent upper-income geographies. By family income level, 18 percent of the families in the AAs are considered low-income families, 19 percent are moderate-income, 27 percent are middle-income, and 36 percent are upper-income. The bank's business strategy is to operate with a community-bank orientation while offering a large-bank range of products. Commercial lending has long been a primary focus of the bank with small business lending considered one of the bank's market niches.

Discussion and Conclusions

Lending Test

The lending test evaluates a bank's performance in terms of the volume of lending, the geographic distribution of loans originated and purchased, the borrower dispersion of loans originated and purchased, the responsiveness to community needs, the level of innovation and flexible products offered, and community development lending activities.

The PE concluded:

The bank had demonstrated a good responsiveness to the credit needs in its assessment areas, taking into account the number and amount of home mortgage, small business, small farm, and consumer loans in its assessment areas.

- A substantial majority of loans were made in the bank's assessment area.
- The bank's record of lending to businesses of different sizes was good. The bank also demonstrated a good geographic distribution of small loans to businesses.
- The bank has a good distribution of loans to individuals of different income levels. The bank's geographic distribution of loans to borrowers of different income levels is satisfactory.
- The level of community development lending is reasonable based on the available opportunities.
- There is a good use of flexible lending practices and programs.

The appellate submission stated that the lending test rating should be "outstanding" based on the information contained in the PE because the bank was consistently ranked as the leading provider of CRA-related loans to low- and moderate-income (LMI) individuals, businesses, and farms in the bank's assessment area.

Lending Activity

A review of the bank's lending tables disclosed that the bank extended a high volume of loans for the evaluation period. While the bank had the largest deposit share in its market, its lending activities also reflected dominance. The market share for small business lending, the bank's acknowledged niche, was commensurate with the bank's deposit share in the MSA and exceeded its deposit share in the non-MSA. The bank ranked first in market share for loans to small businesses, home purchase loans, home-improvement loans, and multifamily real estate loans. Small business, home purchase, and multifamily loans were identified as the most significant credit needs in the community. The bank's market share percentage was significant in these product categories. Additionally, the substantial majority of the bank's loans were within the designated assessment areas. Therefore, the ombudsman concluded that the bank's level of lending reflected an excellent responsiveness to the area's credit needs.

Geographic Distribution

Small business lending represents a significant portion of the bank's business lending. The bank's strategy emphasized business lending, which has long been considered its strength. Additionally, loans for start-up companies were one of the most frequently cited credit needs in the bank's AA. Therefore, when considering all factors, the ombudsman concluded that at the time of the examination, the primary emphasis should be placed on small business lending. The PE also stated that affordable, first-time homebuyer loans and multifamily real estate loans were identified credit needs. As such, performance in home purchase and multifamily lending was weighted heavier than other housing-related products.

Furthermore, the ombudsman's analysis found the bank's percentage of loans in LMI areas ranged from an adequate to excellent level of performance when evaluated against the percentage of housing units or businesses in those geographies. In addition, the following was considered:

- In the MSA, the bank's 34 percent small business market share in low-income geographies exceeded the overall market share. In addition, the bank's 26 percent small business market share in moderate-income geographies equaled the overall market share. The percentage of the bank's loans to businesses with revenues of $1 million or less did not exceed the percentage of businesses in those areas. Small business lending performance in the MSA's LMI areas was considered good.
- The small business market share in the non-MSA's moderate-income areas exceeded the bank's overall small business market share and the percentage of loans to small businesses in the moderate geographies exceeded the percentage of businesses in those areas. This was considered an excellent level of performance.
- Home purchase lending in the MSA's low-income geographies equaled the percentage of housing units in that area and the market share in the geographies exceeded the bank's overall market share. The performance in the MSA's moderate-income areas was not as strong; however, the MSA's home purchase lending overall was considered good.
- In the non-MSA, the bank's market share in moderate-income areas was comparable to its overall market share. The percentage of loans made during this evaluation period was not as comparable to the housing units located in that geography, but overall performance in the non-MSA was also considered good.

- The percentage of multifamily real estate loans in the MSA's moderate-income geographies exceeded the percentage of housing units in that geography and the bank's market share in that geography exceeded its overall market share. Additionally, this lending occurred in an area identified by the city as being in need of revitalization in terms of housing and economic development. Performance in this product relative to geographic distribution was excellent.

As mentioned above, these loan products addressed the identified credit needs of the community, further demonstrating the bank's commitment to help meet community credit needs. Therefore, the ombudsman concluded that the bank's overall geographic distribution of loans was good.

Borrower Distribution

Borrower distribution reflected a strong level of performance measuring borrowers with various income levels and market share measures. The bank's distribution of loans to LMI borrowers ranged from adequate to excellent. Of particular note during this evaluation period was:

- The bank's overall market share of small loans to businesses was 27 percent and ranked first. The bank's market share of loans to businesses with revenues of $1 million or less exceeded its overall market share. The bank made 78 percent of its business loans to businesses with revenue of $1 million or less. This compared very favorably to the overall market's percentage of loans to those businesses. It was also comparable to the percentage of businesses that had revenues of $1 million or less. This was an excellent level of performance in the MSA.
- The performance with small businesses in the non-MSA was quite comparable with the bank's excellent performance in the MSA indicated above.
- In the MSA, home purchase lending to low-income borrowers was significantly lower than the demographic, however, approximately 40 percent of these families have incomes below the poverty level. These families may have difficulty qualifying for housing-related products. Home purchase lending to moderate-income borrowers met the demographic, while the bank ranked first in overall market share. The bank's market share of moderate-income borrowers was comparable to its overall market share. Considering all factors, overall lending performance to LMI borrowers was good in the MSA and non-MSA.
- Consumer loans to LMI households exceeded the demographics, 113 percent and 175 percent, respectively. This represented an excellent level of performance.

As with geographic distribution, these loan products addressed the identified credit needs of the community and were appropriately weighted in determining the overall performance for borrower distribution. These facts indicate the bank's response to the needs of small businesses was excellent and performance in home purchase lending was good. Therefore, it was appropriate at the time of the examination to place the most emphasis on these products. The ombudsman concluded the bank's overall performance in providing credit to borrowers of different income levels was excellent.

Community Development Lending and Innovative or Flexible Lending Programs

There was no disagreement with the assessment that "the bank's level of community development lending was reasonable based on available opportunities." The PE also described several lending programs that were flexible, responsive, and have had a positive impact on the development of the community. These programs utilize standards that make credit available to borrowers that typically have difficulty accessing credit. While some of the programs have been available for several years, the programs continue to generate loans. Therefore, the ombudsman concluded that the bank utilized flexible lending programs, which had a positive impact on the bank's overall rating for the lending test.

Lending Test Overall Conclusion

The bank's volume of lending was significant and substantial within the its assessment areas. Therefore, the bank's performance in the geographic and borrower distribution of credit was key to the bank's overall rating for the lending test. The bank's performance in the geographic and borrower distribution of credit noted above reflected a commitment to helping meet the credit needs of the community. This was particularly true considering the identified credit needs, the bank's product niche or emphasis, the operating environment and the extensive use of flexible lending programs. The bank's overall volume of lending was consistent with the CRA guidelines for an "Outstanding" rating for the lending test.

Investment Test

The bank's performance under the investment test was evaluated in terms of:

- The volume of qualified investment and grants;
- The level of innovation and complexity associated with the investments;
- The degree to which the investments and grants responded to the credit and community development needs of the AA; and,
- The degree to which these investments and activities are not routinely provided by private investors.

The PE concluded:

- The bank's level of community development investments and grants is reasonable, based on the investment opportunities available in the community.
- The bank has taken a leadership role in one significant investment initiative.

The appellate submission stated that the investment test rating of "Low Satisfactory" was not justifiable, given the information in the PE. In addition, the submission stated that management believes their willingness to invest in any economically viable project in their community, coupled with taking the lead in the only limited liability corporation of its kind, in a community where there are limited community development opportunities as noted by the community contacts, should afford the bank a "High Satisfactory" rating.

No additional information was offered during the processing of the appeal that would increase the level of community development investments noted at the time of the examination. The level of qualified investments noted during the CRA review represented less than 1 percent of the bank's tier one capital and the PE noted only one occasion where the bank assumed a leadership position. The ombudsman agreed that the level of investment identified during the examination was accurately categorized as reasonable, given the bank's size and resources. Therefore, he concluded that the assigned "Low Satisfactory" rating was appropriate for the bank's performance on the investment test.

Service Test

The bank's performance under the service test was evaluated in terms of retail banking services (the accessibility of delivery systems, changes in branch locations, and the reasonableness of business hours and services to help meet the AA's needs) and the level of community development services provided in the AAs.

The PE concluded:

- The bank's delivery systems are accessible to all portions of its AA;
- To the extent changes have been made, the bank has improved the accessibility of its delivery systems. Since the last CRA evaluation, the bank acquired a full-service branch in a moderate-income census tract;
- Banking services and hours of operation are tailored to meet customer needs;
- The bank is a leader in providing community development services.
- The appellate submission stated that the PE supporting information supported an "Outstanding" rating for the service test, so an upgrade from a "High Satisfactory" to an "Outstanding" was requested.

The primary focus of the service test is the distribution of full service branches, while still considering alternative delivery systems. The bank's branch distribution in the MSA's LMI areas exceeded the demographic in the low-income area, but not in the moderate-income areas.

Information provided during the processing of the appeal revealed that the volume of ATM transactions in the MSA for ATMs located in or near LMI areas was significant. However, there are no branches or ATMs distributed in moderate-income areas of the non-MSA. Therefore, the overall branch distribution was good.

The PE noted that the bank opened a full service branch in a moderate-income geography, which did improve the accessibility of banking services in that geography. The bank's performance in opening and closing branches was excellent.

Services listed in the PE were considered to determine the reasonableness of the bank's business hours and services. The services listed did not inconvenience any segment of the community. However, the services are not tailored specifically for LMI individuals or geographies and do not represent a significant difference from services offered by other banks. Considering this, the bank's services were adequate.

There was no dispute about the bank's community development services, which was described as excellent. When blending the conclusions of the other tests to determine the overall rating for the service test, the most weight was given to the bank's branch distribution and the community development services. Therefore, the ombudsman concluded an "Outstanding" rating was appropriate for the bank's performance in the service test.

CRA Rating

The ratings in each of the tests contribute to the overall CRA rating. In this case the changing of the rating on the lending test from “High Satisfactory” to “Outstanding” positively affected the overall rating on the bank’s CRA performance. Therefore, the bank’s overall CRA rating was changed to “Outstanding” and a new PE was prepared to reflect the change.

Appeal of “Needs to Improve” CRA Rating and Management Rating of 2

Background

A community bank appealed its CRA rating of “Needs to Improve” assigned by the supervisory office. The PE stated that lending within the bank’s assessment area was lower than the standard for “Satisfactory” performance. The bank believed the conclusion was inappropriate based on the following:

- The bank’s principle line of business had not changed substantially since the previous CRA evaluation that resulted in a “Satisfactory” rating.
- The bank was following the same business strategy, yet the examiners did not properly consider the performance context issues as was done in the prior examination.
- The bank’s business plan and strategy centered on origination of “non-conforming” residential mortgage loans to customers throughout the country. A large number of these loans were made to LMI individuals.

The appropriateness of the management component rating downgrade from 1 to 2 was also appealed.

CRA Rating

Discussion

As reported in the PE, the bank had a low level of lending within its assessment area. For the two-year evaluation period, the bank originated 79 loans equating to 7 percent of all bank HMDA reportable (one- to four-family purchase, home improvement, and home refinance) loans. The facts were not in dispute. The key issue was whether the bank’s low level of lending within its assessment area could result in a satisfactory record of meeting the bank’s community credit needs when considering all relevant factors, including the bank’s performance context.

Banks with assets of less than $250 million are defined as small institutions under the CRA regulation. Small institutions are evaluated under five assessment criteria:

- Loan to deposit ratio;
- Percentage of loans and as appropriate, other lending-related activities located in the bank’s assessment area (lending in the assessment area);

- Record of lending to borrowers of different income levels and businesses and farms of different sizes;
- Geographic distribution of the bank's loans; and,
- Record of taking action in response to complaints about its performance in helping to meet credit needs in its assessment area.

The PE concluded the bank's performance in all the above criteria was found to be reasonable with the exception of lending in the assessment area.

In all CRA evaluations, performance context is an integral component of the analysis. The performance context considers:

- The economic condition and demographics of the assessment area
- Information about lending, investment, and service opportunities
- The bank's product offering and business strategy
- Any limiting factors or constraints
- Past performance
- The bank's public file
- Any other information deemed relevant by the OCC

Performance context is especially important to this bank due to their business strategy and non-traditional product delivery systems. The bank's primary lending activity focuses on non-conforming/sub-prime mortgage secured loans. Management stated that because there was strong competition from several larger institutions in their market area for traditional lending products, that they had identified subprime lending as a viable niche. According to bank management, this strategy and type of lending has affected the bank's ability to generate a significant volume of loans within their assessment area.

The May 3, 1999 FFIEC *Community Reinvestment Act; Questions and Answers Regarding Community Reinvestment* (Qs & As) states that if the percentage of loans and other lending related activities in an institution's assessment area is less than a majority, then the institution does not meet the standards for satisfactory performance only under this criterion. However, its effect on the overall performance rating of the institution is considered in light of the performance context.

In addition, the Qs & As also state that examiners can consider "lending-related activities," including community development loans when evaluating the first four performance criteria of the small institutions performance tests. Community development lending provides support on a performance context basis to the degree that a loan benefits a LMI individual or is made in a LMI geography. Community development is defined as:

- Affordable housing (including multi-family rental housing) for LMI individuals;
- Community services targeted to LMI individuals;
- Activities that promote economic development; or,
- Activities that revitalize or stabilize LMI geographies.

Conclusion

The performance context under which this bank operates is unique. It is a small bank (under CRA criterion) that has a narrow product offering which has affected its ability to provide a significant level of traditional lending within its assessment area. While the bank is compensated for assuming additional risk, the benefits to the customers include availability of credit, debt consolidation, and opportunity to improve their credit rating. Although performance context allows for consideration of items such as business strategy and past performance when evaluating CRA, in this situation it did not provide the degree of mitigation needed to bridge the unusually low level of lending within the bank's assessment area to reach an overall "Satisfactory" rating.

Therefore, considering the above factors the ombudsman concluded that the bank's performance under the CRA was reflective of a "Needs to Improve" rating. While the bank's community development lending had a positive impact on the assessment area performance, its current level did not bring the bank's performance to an overall "Satisfactory" level.

Management Rating

Discussion and Conclusion

The submission also appealed the appropriateness of the 2 management rating. The ROE stated that "board oversight and management supervision are satisfactory; however, they did not provide adequate oversight in complying with the requirements of CRA resulting in a "Needs to Improve" rating. "OCC Bulletin 97–1, Uniform Financial Institutions Rating System, states that the capability and performance of management and the board of directors is rated based upon evaluation factors which include the level and quality of oversight and support of *all* institution activities by the board and management. Based on the noted deficiencies in the bank's overall management and administration of its CRA activities, the ombudsman concluded that the assigned 2 management rating was appropriate.

Appeal of "Needs to Improve" CRA Rating

Background

A community bank appealed its CRA rating of "Needs to Improve" assigned by the supervisory office. The PE stated that the bank's lending performance was in need of improvement, and that the loan-to-deposit (LTD) ratio was less than reasonable, given the bank's size, financial condition, capacity to lend, and assessment area credit needs. It also stated that the public was not aware of the loan products offered by the bank, bank management had a reputation for conservative lending practices, and the community perception was that submitting a loan application would be futile.

The appeal focused on the LTD ratio component of the CRA evaluation process. The bank believed the LTD ratio was reasonable given the demographics, economic factors, and limited lending opportunities in the area.

Discussion

The CRA regulation performance standards' criteria for evaluating a small bank's record of helping to meet the credit needs of its community include an evaluation of the bank's LTD ratio adjusted for seasonal variations and, as appropriate, other lending-related activities, such as loan originations for sale to the secondary markets, community development loans, or qualified investments. The reasonableness of the ratio is assessed considering the performance context in which the bank operates including its size, financial condition, and assessment area credit needs. This ratio is one indicator of a bank's ability and willingness to help meet the assessment area's credit needs.

The OCC recognizes that every bank is unique in its own right and evaluates each bank's CRA performance based on the context in which it operates. In reviewing the bank's performance in their assessment area, the ombudsman considered the following factors:

- The bank's LTD ratio during the examination was 32 percent with an average of 26 percent since the last examination, two years ago. The bank's deposit base included a significantly high level of deposit accounts from public funds, insider relationships, and other large depositors. Depositors with certificates of deposit balances of $28 million have only $2.6 million in loans outstanding. It is also important to note that of the $20 million in demand deposit accounts, $9.5 million or 89 accounts have balances over $50 thousand, with an average deposit balance of $106 thousand. These large depositors contributed to the bank's relatively low LTD ratio.
- The community is heavily banked, with one financial institution for every 800 residents.
- The largest sector of the assessment area is upper-income families; however, in general, the population is declining. In addition, there are no LMI census tracts in the assessment area.
- When considering the number of financial institutions in the assessment area and the significant level of lending to LMI borrowers, additional lending opportunities to this segment of the population is limited.

Conclusion

The performance context under which this bank operates is unique. It includes:

- A high level of deposit accounts from public funds, insider relationships, and other large depositors with low level of loan demand;
- The community is heavily banked with one financial institution for every 800 residents;
- A high level of upper-income individuals within the assessment area;
- A declining population; and
- No LMI census tracts.

Therefore, considering the above factors the ombudsman opined that the bank's LTD ratio was reasonable. In determining the appropriate overall CRA rating, the ombudsman also considered the following:

- The bank's loan distribution reflected a very good penetration among borrowers of different income levels. The bank's loan composition level of 32 percent to low and 27 percent to moderate-income borrowers exceeded the assessment area's composition percentages of 17 percent and 21 percent, respectively.

- The sample of commercial and agricultural loans reviewed indicated that a substantial majority was extended to entities with annual gross revenues of less than $1 million per year.

Based on the bank's performance context and the small bank performance criteria, the bank's performance under the CRA was found to be more reflective of a "Satisfactory" rating. In accordance with the regulation, the bank is helping to meet the credit needs of the communities in which it operates. A revised PE reflecting this change was forwarded to the bank from the supervisory office.

Appeal of "Satisfactory" CRA Rating—Lending and Service Tests

Background

A large interstate bank filed a formal appeal concerning its CRA composite rating of "Satisfactory Record of Meeting Community Credit Needs" (satisfactory). Specifically, the bank appealed its lending test and service test ratings in one multi-state MSA and one state rating. The bank requested:

- Rating upgrades for the lending test and service test and the overall rating in the multi-state MSA and one state, which the bank believed would lead to a composite rating of outstanding;
- Inclusion of additional data in the investment test analysis that inadvertently had not been provided to examiners during the CRA examination. Subsequently, the bank requested an expansion of the ombudsman's review to include a reevaluation of the investment test for the multi-state MSA, one state rating, and the overall rating; and
- Exclusion of a merged institution's data from the review of the bank's CRA performance due to its recent acquisition. Additionally, the bank asked that the examination scope be amended to include more full-scope reviews of bank assessment areas within the state.

The bank offered four rationales to support its appeal for upgraded ratings. First, it felt that the selection of areas for full-scope evaluation unfairly skewed the results of the examination, due to the recent merger and the additional assessment areas created. It also felt that more assessment areas within the one state should have received full-scope review to provide a more balanced picture of the bank's performance in the state. Second, the bank stated that it had an even higher level of performance in the lending and service areas of community development than it had in the prior period when it was rated o*utstanding*. Third, the bank felt its performance compared favorably to another large bank that had been rated o*utstanding* during the same time period. Lastly, the bank provided additional investments made during the period that were inadvertently not provided to the examiners during the exam.

The bank's composite rating and ratings for the one state and multi-state MSA, in question, were based on the examiner's assignment of the following individual test ratings:

Performance Test and Composite Ratings

Rating Area	Lending Test	Investment Test	Service Test	Composite
Bank	High Satisfactory	Low Satisfactory	Low Satisfactory	Satisfactory
State	High Satisfactory	Low Satisfactory	Low Satisfactory	Satisfactory
Multi-state MSA	High Satisfactory	High Satisfactory	High Satisfactory	Satisfactory

Discussion

Lending Test

In evaluating a bank's lending performance, the OCC considers a bank's:

Number and amount of home mortgage, small business, small farm and consumer loans, if applicable, in the bank's assessment area(s);

Geographic distribution of home mortgage, small business, small farm and consumer loans, if applicable, within and throughout its assessment area(s), and within LMI geographies located in its assessment area(s);

Distribution of home mortgage, small business, small farm and consumer loans, if applicable, by borrower income level and small businesses and farms of different sizes;

Community Development lending, including the number and amount of loans, their complexity and innovativeness; and,

Use of innovative or flexible lending practices to address credit needs of LMI individuals or geographies.

The ombudsman's analysis of bank and examination prepared work papers and the CRA PE identified that the bank:

Did not provide its consumer loans for review as part of the lending test evaluation.

Home mortgage and small business lending levels, in terms of number or dollars, had increased since the prior evaluation. However, when the lending volume was compared to demographic data, including the percent of owner-occupied housing units by geography, percent of LMI families within the bank's assessment areas, and the number and location of small businesses, the bank's performance was determined to be similar to the prior period.

Home mortgage and small business lending performance was mixed throughout the state. In one significant assessment area, the bank demonstrated excellent lending performance. However, performance in the remaining state assessment areas, which represent more of the bank's deposits than the above-mentioned assessment area, was generally adequate to poor.

Community development lending within the state was adequate. However, half of the dollar volume of these loans was concentrated within one assessment area.

Several flexible home mortgage-lending products had been developed specifically for LMI borrowers.

Overall home mortgage, small business, and community development lending in the multi-state MSA was considered excellent.

Additionally, the ombudsman concluded that the descriptions of lending performance in the CRA PE were not consistent when describing similar performance among the various rating areas. Consequently, the PE provided a confusing picture of the bank's actual performance.

Investment Test

In evaluating a bank's investment performance, the OCC considers the:

- Dollar amount of qualified investments;
- Innovativeness or complexity of the qualified investments;
- Responsiveness of the qualified investments to credit and community development needs; and,
- Degree to which the qualified investments are not routinely provided by private investors.

The ombudsman's analysis of bank and examination prepared work papers and the CRA PE identified that:

1) Several of the investments the bank provided with its appeal were "qualified investments" and were added to the investment totals.

2) The examiners evaluated the bank's performance using the funded value of the bank's qualified investments rather than the book value. Using the book value increased the total investment dollars in the state and multi-state MSA.

3) The increase in both dollar and number of qualified investments had a positive impact on the investment test rating in the state and bank overall.

4) The qualified investments were responsive to community credit and development needs, but generally did not evidence innovation or complexity and were routinely provided by other private investors.

Service Test

In evaluating a bank's service performance, the OCC considers the:

- Distribution of bank branches among low-, moderate-, middle-, and upper-income geographies.
- Record of opening and closing bank branches, particularly in LMI geographies or primarily serving LMI individuals;

- Availability and effectiveness of the bank's delivery systems for providing traditional and non-traditional retail banking services in LMI geographies and to LMI individuals;
- Range of services provided in low-, moderate-, middle-, and upper-income geographies and the degree to which the services are tailored to meet the needs of those geographies; and
- Extent to which the bank provides community development services and how innovative and responsive they are to assessment area needs.

The ombudsman's analysis of bank and examination prepared work papers and the CRA PE identified that:

1) Generally, the bank's branch and ATM distribution was commensurate with the percentage of households living within the state assessment areas and the multi-state MSA.
2) The bank had a net increase in branches in low-income geographies within the multi-state MSA.
3) Generally the branch and ATM network was accessible to all portions of the bank's assessment areas.
4) The bank's provision of community development services was significant in the multi-state MSA and adequate overall within the state.
5) A number of community development services provided within the multi-state MSA were not included in the PE.
6) Community contacts and government officials, in the multi-state MSA, indicated that the bank was a community leader and strongly influenced community development, especially in economically depressed areas.

Examination Scope

The ombudsman agreed with the bank that the merged institution's data should not have been included in the evaluation of the bank's performance. Additionally, the examiners should have performed a full-scope review of more state assessment areas to better ascertain the bank's performance. However, the ombudsman concluded that altering the examination scope would not change the bank's state or composite rating.

Comparison of Performance with Other Institutions

The bank provided comparisons of its lending and investment data with that of another large bank. Comparing one bank's raw data to another bank's, without an appropriate context, is difficult and does not necessarily result in being able to conclude that performance is similar or dissimilar. In the ombudsman's review, this bank's lending data was compared to nine other large banks examined during the same time period. The conclusion was that this bank's lending data was not inconsistent with other large banks that received a high satisfactory under the lending test.

Conclusion

Based on the above findings and others contained within the PE, the ombudsman concluded that some of the individual test ratings for the multi-state MSA, the state, and the bank overall should be upgraded.

Additionally, it was concluded that the merged institution's data should remain in the PE. The decision to leave the data in the evaluation was based on the bank having an AA in the applicable state prior to the merger. Accordingly, performance in the state would have to be rated and the inclusion of the merged institution's data did not negatively impact the bank's composite CRA rating.

Changing the examination scope in the state, in question, may have helped develop a better context in which to assess the bank's performance and provided more support for the rating assigned. However, analysis of this additional data would not change the state and composite ratings.

The revised ratings are reflected in the following table.

Performance Test and Overall Ratings*

Rating Area	Lending Test	Investment Test	Service Test	Overall Rating
Bank	High Satisfactory	**High Satisfactory**	**High Satisfactory**	Satisfactory
State	High Satisfactory	**High Satisfactory**	**High Satisfactory**	Satisfactory
Multi-state MSA	**Outstanding**	High Satisfactory	**Outstanding**	**Outstanding**

*Ratings in bold were upgraded

Appeal of "Needs to Improve" CRA Rating—Lending to LMI Individuals

Background

A small bank filed an appeal concerning its CRA rating of "Needs to Improve Record of Meeting Community Credit Needs" (NTI). During the evaluation period, the bank's total assets almost doubled, due mostly to a unique lending arrangement with a large local corporation. The corporation solicited a bid and subsequently selected the bank as its preferred lender for making stock-purchase loans for its eligible employees. The stock offerings are at the sole discretion of the corporation with the bank's role to make stock-secured loans to corporation employees. Lending under this program has been so substantial that a significant majority of the loans had to be participated with other financial institutions. Almost all of these loans were made to middle- and upper-income individuals.

The bank's assessment area contains no LMI census tracts. LMI individuals and families represent 20 percent of the population within the assessment area. Additionally, the area is experiencing a high level of population growth with the majority of the growth in middle- and upper-income families.

In reviewing the bank's lending pattern during the evaluation period, the examiners concluded that the bank's record of lending to LMI borrowers was poor and did not reasonably reflect the assessment area demographics. Of the loan products sampled, very few of the number and dollar amount were to LMI borrowers. The primary reason for this was the substantial volume of stock-purchase loans. The examiners concluded that the bank's performance under the remaining small bank test criteria was reasonable.

In its appeal, the bank contends that its performance cannot be fairly evaluated using the criteria in 12 CFR Part 25, Appendix A, of the CRA Regulation due to the unusual circumstances created by the stock-purchase loan program. The bank also contends that the percentage of LMI families within the assessment area and the number of stock-purchase loans made; caused the examiners to conclude that the level of lending to LMI borrowers was very poor and loan originations did not reasonably reflect assessment area demographics. The bank claims these conclusions misrepresent the facts.

To fairly evaluate the bank's lending across income levels, the bank believes that OCC should exclude the stock-purchase loans from the analysis. While the examiners cited the stock purchase program as the bank's primary product line, the bank contents that it is not a product line because it cannot be marketed to the general public nor can the public purchase the stock. The bank considers its major product lines to be consumer loans (secondary market real estate, Home Mortgage Disclosure Act (HMDA) reportable, home equity and auto loans).

The bank states that its consumer lending has not been affected by the stock-purchase program. Consumer lending to LMI borrowers represented 25 percent of the loans examiners sampled. This lending pattern exceeds the 20 percent level of LMI families within the bank's assessment area. The bank states that due to the high cost of housing in the assessment area, a large number of homes are unaffordable to LMI families. Yet the bank claims that 16 percent of the loans in the examiners loan sample were secondary market, HMDA reportable and home equity loans to LMI borrowers.

Discussion

Since there was no dispute with the case facts, the issue to resolve was a determination on how the stock secured loans should be treated in the analysis of lending to borrowers of different income levels.

The CRA Regulation, at 12 CFR 25.26, states that one of the small bank performance criteria is "the bank's record of lending to and, as appropriate, engaging in other lending-related activities for borrowers of different income levels. . . ." Part 25.21(b) of the regulation indicates that the OCC applies the small bank performance standards in the context of a bank's assessment area:

- Demographics;
- Lending, investment and service opportunities;
- Product offerings and business strategy;
- Capacity and constraints; and
- Past performance.

The regulation's preamble provides some clarification of this part by adding that examiners consider this data to understand the context in which the bank's performance should be evaluated. Additionally, the regulation and CRA examination procedures focus examiners' attention on residential real estate, small business, small farm, community development and to a much lesser degree consumer loans, not commercial loans. While the regulation does not require that lending match assessment area demographics, examination procedures direct examiners to compare the ratio of loans made to LMI families to the percentage of LMI families within the assessment area.

Conclusion

Based on the bank's business strategy, product offerings, and the lack of previous CRA issues, the stock purchase loans should be considered in the evaluation of the bank's CRA performance. However, this arrangement is also an appropriate "performance context" issue. Other than the stock purchase loans, the data reviewed indicated that the bank's other lending activities during this evaluation period were consistent with past evaluation periods. The bank's real estate related lending had also increased over past periods.

The bank's real estate-related loans and total consumer lending to LMI individuals and families provide a reasonable distribution by borrower income level. Considering the examiners found the bank's performance reasonable in the remaining performance criteria, the rating was upgraded to "Satisfactory."

However, because of the bank's growth strategy, the board was strongly encouraged to reconsider the size of the its assessment area. It was determined that while the regulation does grant some flexibility in designating an assessment area smaller than an MSA or political subdivision, the bank's strong capital, earnings and lending record support its ability to reasonably serve a larger area than its current assessment area boundaries.

Appeal of "Needs To Improve" CRA Rating—Violations of ECOA

Background

A designated limited purpose bank filed an appeal concerning its composite CRA rating of "Needs to Improve Record of Meeting Community Credit Needs" (NTI). The bank received a "Satisfactory" rating under the community development test, but the overall rating was downgraded to NTI based on an alleged substantive violation of the Equal Credit Opportunity Act (ECOA) and Regulation B. In particular, the bank claims that the OCC examiners did not appropriately credit its subsequent efforts, during the on-site examination and shortly thereafter, to address the fair lending issues raised during a concurrent fair lending examination in determining its CRA performance rating.

Examiners found differences in the treatment of Spanish-language and English-language applicants/cardholders in one of the bank's designer label credit cards and determined that a reason to believe a substantive violation of ECOA had occurred. The underlying cause of the alleged violation was deficient internal control systems. After a thorough review of the alleged fair lending violation, the OCC referred the case to the U.S. Department of Justice for further investigation. The bank appealed that decision, but the ombudsman's office concluded that there was sufficient information to support the examination findings. Subsequently, the OCC referred the matter to the Department of Justice.

Discussion

While the bank maintains that it did not violate the ECOA or Regulation B, it acted quickly and initiated a number of prospective and retrospective actions to address the examiner's fair lending findings. After discussions with the examiners, the bank began implementing actions that were largely completed during or shortly after the completion of the fair lending examination. Regarding retrospective actions, the bank voluntarily:

1) Merged the application handling for Spanish-language and English-language programs under one underwriting process;
2) Reviewed all Spanish-language applicants denied credit to determine if they would have been approved under the English-language program and then offered them credit;
3) Increased credit lines of Spanish-language applicants who had received lower lines than similarly situated English-language applicants; and
4) Offered a special balance consolidation promotion to Spanish-language cardholders who had previously not received such offers.

Prospectively, the bank voluntarily:

1) Conducted fair lending training for pertinent employees;
2) Instituted a policy that all new employees in the risk, marketing and credit departments receive fair lending training;
3) Mandated fair lending recertification of employees annually;
4) Improved internal controls and oversight systems;
5) Established procedures for legal and compliance program reviews; and
6) Improved audit review of fair lending issues.

The bank believes that if its actions taken to address the fair lending concerns had been appropriately considered, it would have received a "Satisfactory Record of Meeting Community Credit Needs" rating. In the appeal letter, the bank cited prior instances in which the ombudsman's office had amended ratings after giving consideration to post-examination actions not considered by the examiners.

The CRA, at 12 CFR 25.28(c), states that:

> Evidence of discriminatory or other illegal credit practices adversely affects the OCC's evaluation of a bank's performance. In determining the effect on the bank's assigned rating, the OCC considers the nature and extent of the evidence, the policies and procedures that the bank has in place to prevent discriminatory or other illegal credit practices, any corrective action that the bank has taken or has committed to take, particularly voluntary corrective action resulting from self-assessment, and other relevant information.

At issue is whether the examiners appropriately considered the bank's corrective actions in arriving at the bank's CRA performance rating.

Conclusion

The "Needs to Improve" rating was upheld and the examiners appropriately considered the bank's efforts to address the fair lending violation in arriving at that rating. However, the bank's substantial action to correct the violation did not mitigate the other factors OCC considers in such cases. The extent of the evidence regarding the treatment of individuals under the Spanish-language product was material, supporting a "reason to believe" that a pattern or practice of disparate treatment existed. Furthermore, the bank, at the time, did not have sufficient internal controls, policies, and procedures in place to prevent such practices. The ombudsman acknowledged the merits of the bank's actions to address this issue. The benefit of such should positively affect the bank's CRA performance during future evaluation periods.

Appeal of "Needs to Improve" CRA Rating

Background

A bank filed an appeal of their CRA rating of "Needs to Improve" (NTI) assigned by the supervisory office. The PE stated that the bank's loan-to-deposit (LTD) ratio was less than reasonable, considering seasonal variations, given the bank's size, financial condition, capacity to lend and assessment area credit needs.

The appeal indicated that the Board believes the CRA rating should have been "Outstanding" or at least "Satisfactory" based on the following:

- The NTI resulted from a "litmus test" of the LTD ratio and that the Federal Act imposed no such legalistic test.
- The bank's officers and directors had already considered many of the suggestions in the report of examination to improve the rating.
- The particular circumstances of the bank and the economic conditions of the surrounding community supported a higher rating.
- There was no evidence of discrimination, self-dealing or insider abuse.

Discussion

The analysis of the appeal included a review of the issues highlighted in the bank's letter, the PE and all supporting documentation, discussions with OCC personnel, and an on-site visit to the bank.

While the community where the bank is located is experiencing stagnant population growth, its designated assessment area is the whole county which includes the 6 other communities. The bank has made the majority of its loans within the assessment area, and the banker's familiarity with the county was evidenced during the community tour. The PE noted that the distribution of loans reflected a reasonable penetration among individuals of different income levels and businesses of different sizes.

The CRA regulation performance standards' criteria for evaluating a small bank's record of helping to meet the credit needs of its community include an evaluation of the bank's LTD ratio adjusted for seasonal variation. The reasonableness of the ratio is assessed given the bank's size, financial condition, and assessment area credit needs. This ratio is a clear indicator of a bank's ability or willingness to help meet the assessment area's credit needs.

The bank's 21 percent LTD ratio at the quarter-end of the evaluation period was significantly lower than similarly situated institutions. There are six other commercial banks serving the assessment area, three are locally owned and three are branches of community banks headquartered outside of the county. The three locally owned banks all had LTD ratios which far exceeded the bank's, ranging from 59 percent to 80 percent at the same quarter-end. The bank's average LTD ratio during the CRA assessment period was 17 percent compared to the other three banks' average of 62 percent. Although there is strong competition in the assessment area, the board and management's lending practices are the primary reasons for the bank's low LTD ratio.

Conclusion

The OCC recognizes that every bank is unique in its own right, and evaluates each bank's CRA performance based on the context in which it operates. This bank was atypical in that its loan portfolio was less than its total capital, indicating new lending opportunities could be explored in a safe and sound manner. The ombudsman is not advocating relaxation of credit standards, but rather a program to increase lending slowly and gradually, and most importantly, safely. The absence of evidence of discrimination, self-dealing, or insider abuse are not significant factors in the assignment of an overall CRA rating.

The ombudsman concurred with the "Needs to Improve" rating.

Appeal of “Substantial Non-Compliance” CRA Rating

Background

A formal appeal was filed concerning a rating of “Substantial Non-compliance Record of Meeting Community Credit Needs” received during the CRA examination.

The OCC’s CRA PE listed the following factors in support of the bank’s rating:

- Lending patterns show conspicuous gaps in lending in LMI geographies which are predominately African-American and Hispanic neighborhoods
- The geographic distribution of loans originated show very poor lending penetration in LMI geographies; and
- Lending levels reflect very poor responsiveness to assessment area credit needs.

The PE designated the performance ratings as “Substantial Non-Compliance” for the Lending Test and “Low Satisfactory” for the Investment and Service Tests. The PE also noted, consistent with the CRA regulation, that the Lending Test is weighted more heavily than the Investment and Service Tests when arriving at a composite CRA rating.

The bank believed that each of the three performance ratings should have been higher than assigned during the examination, and that the overall rating should have been “Satisfactory Record of Meeting Community Credit Needs.”

Discussion

The evaluation of a bank’s CRA activities requires a full understanding of the performance context in which it operates. The performance context considers the economic condition and demographics of the assessment area, competition, and the types of products and services offered by the bank. While the CRA activities of other similarly situated financial institutions are considered, bank-by-bank comparisons are not a component of the overall rating process.

The ombudsman’s analysis included a review of the issues highlighted in the bank’s appeal letter, the ROE, the PE, and all supporting documentation. Additionally, extensive discussions were held with appropriate bank management and OCC supervisory personnel.

The Lending Test

The Lending Test evaluates a bank’s record of helping to meet the credit needs of its assessment area(s) through its lending activities by considering a bank’s home mortgage, small business, small farm, and community development lending. Based upon the ombudsman’s analysis of the bank’s lending performance during this evaluation period, it was clear that there were conspicuous gaps in lending, particularly, in LMI geographies. The lending gaps identified during the examination were inclusive of small business, home mortgage, home improvement, and community development loans. Further review of the HMDA data indicated that lending opportunities did exist within these same geographies. The bank’s limited offering of HMDA products and a lack of marketing efforts had affected its ability to effectively compete with other lenders within these geographies. Therefore, because of the significance of a potential SNC rating, the ombudsman expanded the analysis to include retail (non-HMDA) lending products for the same evaluation period.

The ombudsman carefully reviewed the Lending Test analyses, related information contained in the examiners' working papers, and the additional data provided by the bank. In considering all loan products, the ombudsman found that the volume of the bank's lending within its assessment area to LMI geographies essentially mirrored the examination findings. The inclusion of retail (non-HMDA) products was not a significant factor. Some material conspicuous gaps in both lending and in the origination of loan applications remained, particularly in LMI geographies.

Comparing all findings with the Lending Test rating guidelines and after a detailed and extensive assessment of all the facts and circumstances, the ombudsman concluded that the bank's performance under the Lending Test, was more appropriately reflective of a "Needs to Improve" rating and not the "Substantial Non-Compliance" rating as assigned in the PE.

The Investment Test

The Investment Test evaluates a bank's record of helping to meet the credit needs of its assessment area(s) through qualified investments that benefit its assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s).

The ombudsman performed a detailed review of the examiners' findings, supporting working papers and information contained in the appeal and provided by the bank. Most notable was the bank's investment in and support of two local community development corporations. Qualified investments in these types of organizations are consistent with the CRA. The regulation further encourages banks to make investments that are innovative, complex, and not routinely provided by the private sector. While the bank had some participation in qualified investments, the ombudsman determined that the bank's investment activity did not represent innovative and/or complex transactions or investments that are not routinely provided by private investors. As a result of a detailed analysis of all documentation, and the application of the CRA Investment Test rating guidelines, the ombudsman concluded that the "Low Satisfactory" rating assigned in the PE was appropriate.

The Service Test

The Service Test evaluates a bank's record of helping to meet the credit needs of its assessment area(s) by analyzing both the availability and effectiveness of a bank's systems for delivering retail banking services and the extent and innovativeness of its community development services.

The ombudsman performed a detailed review of the examiners' findings, supporting working papers and information contained in the appeal and provided by the bank. The ombudsman recognized and considered the other efforts the bank has made relative to the service test including alternative product delivery systems, the introduction of debit cards, and the opening of a new branch in a moderate-income geography. However, as a result of a detailed analysis of all documentation, and application of the CRA Service Test rating guidelines, the ombudsman concluded that the "Low Satisfactory" rating assigned in the PE was appropriate.

Conclusion

The intent of CRA is to encourage banks to help provide credit products and services throughout its assessment area, including LMI geographies and individuals. While the ombudsman recognized the bank's efforts in general, its overall performance was poor, specifically under the Lending Test.

Owing to the heavier weighting of the Lending Test in the overall rating process, the "Needs to Improve" Lending Test rating consequently changed the bank's overall CRA rating from the "Substantial Non-Compliance Record of Meeting Community Credit Needs" to a "Needs to Improve Record of Meeting Community Credit Needs." A revised CRA PE was prepared to reflect these changes and forwarded to the bank by the supervisory office.

Miscellaneous Safety and Soundness Issues

Appeal of the Bank Secrecy Act Report of Examination

Background

A bank formally appealed the examination conclusions concerning the activities of two foreign correspondent demand deposit accounts.

The review of two accounts, used by the foreign correspondents for currency exchange settlement, reflected unusual and repetitive dollar amount transactions that appeared suspicious in nature. The report of examination (ROE) stated that management must have a clear understanding of the manner in which all correspondent bank accounts are being used and the correspondent banks' controls to ensure that the account is being used solely for legitimate business purposes. In addition, the bank should periodically test accounts to determine whether or not it appears that the correspondent's controls may have been circumvented. All potentially suspicious activity should be investigated and documented, and a suspicious activity report filed, if appropriate.

The appeal submission stated that management disagreed with the OCC recommendations, as the accounts in question were merely checking accounts maintained by a correspondent bank.

Discussion

As discussed in the *Comptroller's Handbook* booklet, "Bank Secrecy Act/Anti-Money Laundering" (September 2000), correspondent bank accounts are accounts banks maintain with each other on their own behalf and in their own names. Correspondent bank account relationships are maintained between domestic banks and between domestic and foreign banks. The relationships between domestic and foreign banks may incur a heightened risk of money laundering.

Banks use international correspondent bank accounts for a variety of legitimate business purposes. Many are used to facilitate international trade and investment activities. Others are used for settlement purposes for funds transfer activity and clearing of foreign items. These accounts are designed to move legitimate funds and assets swiftly and securely around the world.

International correspondent bank accounts may pose increased risk of potential illicit activities, including money laundering. Three of the more common types of activity found in international correspondent bank accounts that should received heightened security are funds (wire) transfer, correspondent accounts used as "payable through accounts" and "pouch/cash letter activity." This heightened risk underscores the need for effective and comprehensive systems and controls particular to these types of accounts.

A bank must exercise caution and due diligence in determining the level of risk associated with each of its correspondent accounts. Information should be gathered to understand fully the nature of the correspondent's business. Factors to consider include the purpose of the account, whether the correspondent bank is located in a bank-secrecy or money-laundering haven, the level of the correspondent bank's money-laundering prevention and detection efforts, and the condition of bank regulation and supervision in the correspondent's country. The level of perceived risk in each account relationship, including the availability of the account to third parties, should dictate the nature of risk management. Banks must comply with 12 CFR 21.11 and 21.21 and 31 CFR 103.18 and report transactions that have no apparent lawful purpose or are not the sort in which a particular customer would normally be expected to engage.

Conclusion

After carefully reviewing the conclusions and recommendations in the ROE, along with a comprehensive discussion with bank management, the ombudsman concluded that the comments in the ROE were reasonable and relevant.

Appeal of the Allocated Transfer Risk Reserve Requirement

Background

A bank formally appealed the OCC's decision regarding the allocated transfer risk reserve (ATRR) requirement for a credit transaction with a foreign-based obligor. The OCC supervisory office had concluded that under the Interagency Country Exposure Review Committee (ICERC) rules, the transaction was "restructured to avoid delinquency," and remained subject to ATRR requirements.

The bank's correspondence outlined the following as the basis for the appeal:

The transaction did not constitute restructured debt and therefore was not subject to ATRR requirements.

The loan and related transactions were effected by the bank to assist an existing customer in retiring higher interest rate debt, and at the same time, remove a weak asset from the bank's portfolio, replacing it with a stronger, different asset.

Discussion

The ICERC rules are intended to require banking institutions to recognize uniformly the transfer risk and diminished value of international assets that have not been serviced over a protracted period of time.

The bank entered into this credit transaction in order to facilitate the purchase of a matured certificate of deposit (CD) placement from its investment portfolio. The CD was from a failed financial institution in a foreign country. An extension of credit was made to an international borrower to purchase the CD from the bank and use the proceeds to extinguish its debt with another financial institution located in the same foreign country. The extension of credit was made without collateral requirements, and without a defined repayment plan.

As noted in the bank's credit presentation, the proceeds of the loan were downstreamed to two of its affiliates operating in the foreign country. The ultimate source of repayment was the cash flow from these affiliates. Also, it was anticipated that the bank would extend this loan as a five-year amortizing loan directly to one of the affiliates.

Conclusion

While the restructure may have positively postured the bank from a credit risk perspective, the following was still applicable:

The restructure was not considered "new money" per the ICERC rules. ("New money" is not subject to ICERC ATRR requirements.) The foreign exposure had not been eliminated. Therefore, the ombudsman concluded that the OCC supervisory office's decision that the credit transaction, as restructured, was still subject to ATRR requirements was appropriate.

Appeal of the Requirement to File a Section 914 Notification

Background

The ombudsman received an appeal from a bank who had been formally requested by the supervisory office to file a Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) Section 914 notice for an individual who was proposed to manage a mortgage banking department.

The supervisory office and bank management had exchanged correspondences and had met on several occasions to discuss the bank's establishment and structure of a mortgage banking division. The supervisory office concluded that the responsibilities of the position meet the definition of an "executive officer" and require the bank to file a Section 914 of FIRREA Notice, in accordance with 12 CFR 5.51, particularly because there are no other officers with mortgage banking experience.

The bank appealed this conclusion, stating that the individual had been hired to start up and then manage a limited mortgage banking department for the bank, but the officer would do so under board-established policy and would not exercise significant influence over, or participate in, major policymaking decisions of the bank.

Discussion

The statute, 12 USC 1831i(a) "Prior Notice Required," states:

> An insured depository institution or depository institution holding company shall notify the appropriate Federal banking agency of the proposed addition of any individual to the board of directors or the employment of any individual as a senior executive officer of such institution or holding company at least 30 days (or such other period, as determined by the appropriate Federal banking agency) before such addition or employment becomes effective, if—

> (1) the insured depository institution or depository institution holding company is not in compliance with the minimum capital requirement applicable to such institution or is otherwise in a troubled condition, as determined by such agency on the basis of such institution's or holding company's most recent report of condition or report of examination or inspection; or
>
> (2) the agency determines, in connection with the review by the agency of the plan required under section 38 [12 USC 1831o] or otherwise, that such prior notice is appropriate.

The implementing regulation 12 CFR 5.51 defines a senior executive officer as follows:

> 12 CFR 5.51(c)(3) *Senior executive officer* means the chief executive officer, chief operating officer, chief financial officer, chief lending officer, chief investment officer, and any other individual the OCC identifies to the national bank who exercises significant influence over, or participates in, major policy making decisions of the bank without regard to title, salary, or compensation. The term also includes employees of entities retained by a national bank to perform such functions in lieu of directly hiring the individuals, and, with respect to a Federal branch operated by a foreign bank, the individual functioning as the chief managing official of the Federal branch.

Conclusion

Through discussions with the board of directors during the appeals process, it was learned that subsequent to the appeal submission the president/chief executive officer of the bank had resigned from those responsibilities. The newly appointed president has experience in mortgage banking. The ombudsman concluded that these executive management changes required the board to revise their original plan for the mortgage banking business. The board was requested to not only reaffirm their desire and commitment to enter into the new business enterprise, but to also re-examine their plan for the management of the operation.

Appeal of the Criterion used to Examine a Community Development Focused Bank

Background

A bank with a community development (CD) focus formally appealed the criterion used to examine the bank. The appeal pointed out that by pursuing the CD focus which was the bank's mission, the bank was in direct conflict with some of the examination criterion employed by the OCC.

In its appeal the bank expressed concern that the OCC's evaluation of some component ratings is not sensitive to the obstacles facing banks with a CD focus. To illustrate this point, the appeal stated that the bank's CD focus works contrary to profit maximization (earnings) by:

- Creating mortgages that are smaller, more labor intensive, and take longer to close than traditional mortgages.
- Financing businesses with smaller loan amounts, and principals lacking the financial sophistication and expertise of traditional borrowers.
- Serving consumers who, on the deposit side, are characterized by having low balances and requiring a great deal more time and attention due to cultural, linguistic, and experiential difficulties, and who, on the loan side, are disadvantaged by nonexistent, inadequate, or unsatisfactory credit histories; in addition, these consumers have earning streams that are inconsistent, small, and/or from non-traditional sources.

The appeal further stated a CD-focused bank's approach to offsetting these inherent disadvantages is to seek available financial assistance from public and private sources supportive of its mission. A significant source of offset comes from within the U.S. Treasury Department in the form of a Bank Enterprise Act (BEA) award. Banks with a CD focus are entitled to these awards based on accomplishing preset goals consistent with its mission. Despite documentation showing the bank's eligibility for these funds, in this instance the examiners discounted them because of their non-traditional status.

The appellate submission noted that, unlike investors in most banks that are motivated to acquire new capital and accumulate additional capital based solely on maximizing profit, a bank with a CD focus looks for a balance between profits and service to the LMI community. As emphasized above in the discussion of earnings, banks with a CD focus have non-traditional means of raising additional capital such as awards or grants from community groups or other banks.

Additionally, the appeal stated that management's ability to budget and project financial outcomes for a bank with a CD focus are severely constrained by the unavailability of comparable data. It further notes, that by definition, the customers of a bank with a CD focus have not been well served by traditional banks and available data is very limited.

Discussion

The corporate process and requirements for chartering a bank with a CD focus is subject to the same standard requirements as any other bank. However, there is a special condition that banks with a CD focus must include the nature of its activities in the articles of association. Specifically, the articles must state:

- The business of the association will be designed to primarily promote the public welfare consistent with the requirements for national bank investment in the community development projects pursuant to national banking laws and regulations, including 12 CFR 24 (Eleven) and 12 CFR 24.
- The bank must obtain prior written approval of the OCC before amending its articles of association to alter its business operations from those of a community development focus.

There are no other special provisions or requirements designed for banks with a CD focus.

Conclusion

As the ombudsman considered whether the examination criterion of the OCC represents a conflict for banks with a CD focus, he recognized the "intrinsically more challenging undertaking" of serving disadvantaged communities that these institutions face. However, the financial health of any banking organization is critical to fulfilling its obligation to the stockholders and the community it serves. As CD banks pursue a balance between serving LMI communities and profitability, the financial health of these institutions becomes increasingly important. Financially stable community development institutions will have longevity, which will allow them to maximize the positive impact on their communities. The ombudsman concluded that the existing safety and soundness criterion contributes to achieving this longevity. In the OCC's evaluation of a bank's performance under the CRA, a bank with a CD focus receives recognition for their efforts to provide financial services to LMI communities.

The OCC is committed to ensuring that its supervisory conclusions consider the uniqueness of each institution in assigning ratings that reflect the safety and soundness of its operation. The ombudsman offered assurance that the agency will continue to evaluate the issues confronting institutions with a community development focus to ensure there is a reasonable chance for their success.

Appeal of "Noncompliance" with an Article of the Bank's Formal Agreement

Background

A community bank appealed the "noncompliance" conclusion on the bank's level of compliance on a particular article in the bank's formal agreement. The article stated:

> Within ninety days of signing the agreement, the Board is required to establish a compliance program to cover all applicable non-consumer laws and regulations. The program shall include a policy and procedures manual, an audit review system, a mechanism for corrective actions when violations occur and a system of training to ensure clear communication of requirements. A copy of the program shall be forwarded to this Office for review.

During the next examination, the supervisory office categorized the bank's level of compliance as "noncompliance" with the following narrative explanation:

> The timeframe for accomplishment of this Article had not expired when we conducted our review. During the examination, management provided a written request for a short extension of the ninety-day requirement to allow the Board to approve the policy at their regular Board meeting. This request was approved and the Board approved the program subsequent to our examination. We will review the program during the next quarterly review, and provide any needed communication to the Board.

Discussion

The OCC has an internal operating procedure that defines the options for assessing compliance with enforcement actions. These include compliance, partial compliance, or noncompliance, with the following definitions:

> **Compliance:** The bank's action(s) to accomplish the primary objective of the article/document are effective. Any additional actions that are still necessary are technical in nature and are easily completed in the normal course of business.
>
> **Partial compliance:** The bank has worked to achieve compliance. However, additional efforts are necessary to fully meet the primary objective of the article/document.
>
> **Noncompliance:** The bank's action(s) to comply with the provisions of the article/document are unsatisfactory. Even though there may be effort(s) on the part of the bank to achieve compliance, little or no progress has been made toward meeting the primary objective of the article/document.

The supervisory office concluded that the bank was in "noncompliance" because the time frame for action had not expired. The internal operating procedure details that the OCC must perform an initial on-site assessment of a bank's compliance with a new enforcement action within 60 days of the latest due date in the enforcement action. The procedures do not address which of the three ratings are appropriate in a case where the due date has not expired.

Conclusion

The ombudsman concluded that if the time frame for compliance has not expired, the level of compliance with an article should not be evaluated. Therefore, the conclusion on the level of compliance on the article was changed to "no action required to date." The field office forwarded revised ROE pages to the bank to reflect this change.

Appeal of a Denial of a FIRREA Section 914 Notice

Background

The ombudsman received an appeal of a denial of a FIRREA Section 914 notice of a bank's proposal to have an individual serve as a director for a troubled institution. The disapproval was based on the individual's involvement in a complex financial transaction while serving as an executive officer of another bank. The denial letter stated the lack of judgment displayed in the transaction reflected negatively on the individual's competence, character, and integrity. The appellate submission stated that the events that provided the basis for the OCC's denial should be viewed in a different perspective and the transaction serves as evidence of both the integrity and competence of individual asking to serve.

Discussion/Conclusion

The statute, 12 USC 1831i(e), "Standard for Disapproval," states:

> The appropriate federal banking agency shall issue a notice of disapproval with respect to the notice submitted pursuant to subsection (a) if the competence, experience, character, or integrity of the individual with respect to whom such a notice is submitted indicates that it would not be in the best interests of the depositors of the depository institution or the best interest of the public to permit the individual to be employed by, or associated with, the depository institution or depository institution holding company.

In this case the ombudsman considered all aspects of the case including interviews with the board of directors of the institution where the transaction occurred, the person's experience in troubled institutions, and an interview of the individual asking to serve as a director. The information obtained in the ombudsman's review did not eliminate the concern caused by the transaction. In addition, the decision to disapprove the individual was not inconsistent with the provisions of 12 USC § 1831i(e). Therefore, the ombudsman did not reverse the prior disapproval of the proposal to appoint the individual to the board of directors for the troubled institution.

Addendum: Given the personal nature of 914 requests, specific details of the referenced financial transaction are not disclosed to maintain confidentiality.

Appeal of Denial of *de Novo* Charter

Background

An organizing group appealed the decision of the OCC's licensing division, Bank Organization Structure (BOS) to deny their application to establish a *de novo* chartered bank.

The organizing group expressed concern and disagreement with several reasons provided in the denial letter as the basis for denying the charter application. The group's appeal primarily focused on:

1. Inconsistencies in what they were told during the field investigation and what the denial letter stated;
2. Concerns expressed in the denial letter with the organizing group's lack of banking experience;
3. OCC concerns with the proposed bank's operating plan;
4. OCC comments about the proposed president/chief operating officer (CEO); and
5. Comments in the denial letter that indicate the group had not provided information on their plans to market the proposed bank's stock.

Discussion

While all concerns in the appeal were investigated and discussed with the appropriate parties, the ombudsman decided that opining on the propriety of the comments presented in the denial letter would not lead to a decision on whether a charter should be granted. The ombudsman determined the best approach to resolve this appeal would be to independently assess the information in the BOS application file and make a determination on the merits of the information as to whether the charter should be granted.

After reviewing the information, the ombudsman applied the criteria outlined in the regulation established for the purpose of providing guidance on granting bank charters to organizers of a proposed bank. 12 CFR 5.20, "Organizing a bank," is explicit in outlining the importance of the operating plan on the OCC's decision to grant a national charter. Specifically:

> (h) *Operating plan*—(1) *General.* (i) Organizers of a proposed national bank shall submit an operating plan that adequately addresses the statutory and policy considerations set forth in paragraphs (e) and (f)(2) of this section. The plan must reflect sound banking principles and demonstrate realistic assessment of risk in light of economic and competitive conditions in the market to be served.
>
> (ii) The OCC may offset deficiencies in one factor by strengths in one or more other factors. However, deficiencies in some factors, such as unrealistic earnings prospects, may have a negative influence on the evaluation of other factors, such as capital adequacy, or may be serious enough by themselves to result in denial. The OCC considers inadequacies in an operating plan to reflect negatively on the organizing group's ability to operate a successful bank. [12 CFR 5.20(h)]

The group's operating plan contained inconsistencies and assumptions that were not adequately explained. As an example, it was difficult to understand how the proposed institution would achieve deposit growth of four percent per year when the entire market had only experienced average growth of one percent in the four years presented in their deposit analysis. Additionally, a market penetration strategy that assumed the bank could pay less than market rate on deposits, when other banking professionals interviewed indicated deposits in that area were rate sensitive, did not appear realistic.

Conclusion

While the group was convinced that there was a need for a locally owned bank, they did not submit an operating plan that demonstrated the proposed bank could reasonably be expected to achieve and maintain profitability. The other issues discussed in the denial letter by themselves were not insurmountable had the operating plan been sound. While those issues did not form the basis for the ombudsman's decision, they offered no support to warrant granting a charter to the organizing group. In considering whether any factors were present to mitigate the weaknesses in the operating plan, the ombudsman determined there were no other factors to offset weaknesses of the plan. Therefore, the ombudsman upheld the denial of the charter, based on the poor operating plan.

Appeal of an OCC's Denial of Branch Relocation

Background

A bank formally appealed the OCC's denial of an application to relocate a particular branch to another location within the same city. Management's primary basis for the appeal was that they believed the relocation was favorable from an economic and CRA perspective. Management also believed that the bank had received inequitable treatment from the supervisory office.

Discussion

The OCC is required by law and regulation to take into account the bank's record of performance under the CRA when evaluating relocation (and other) applications. At the time of the relocation application, the bank's CRA record of performance was rated "Needs to Improve."

Conclusion

The denial was appropriate in light of the bank's CRA record of performance at the time of the decision. However, during the processing of the appeal, the bank informed the ombudsman that it had made an investment of $1.6 million in mortgage-backed securities through a particular public acceptance corporation.

In light of the recent qualified investment, and with an understanding of the economic benefit to the bank, the ombudsman opined that the OCC should approve the relocation with a "pre-consummation" requirement. Bank management was allowed to proceed with the lease negotiations; however, the branch could not relocate until a new relocation application was filed and approved, the supervisory office performed a CRA examination, and the bank received at least a "Satisfactory" rating in its record of performance under the CRA. This decision was subject to the bank not encountering any severe financial, operational, or other difficulties before the new application was approved.

After careful consideration of all the facts and circumstances, the ombudsman found no evidence that the bank received inequitable treatment from the supervisory office.

Appeal of the Treatment of Credit Cards by a Liquidating Entity

Background

A credit card bank, in liquidation, appealed the OCC's decision regarding the continued existence and treatment of its private-label credit cards. With a few exceptions, the credit card portfolio had been sold to an independent third party (buyer). The credit card bank was in liquidation and concluding its activities. In addition to the previously issued disclosures, the OCC specifically requested that the credit card bank send out stickers to be affixed to the outstanding cards with current information as to customer service and ownership of the account.

The bank appealed that decision based on the following:

- The substantial expense ($2–3 million) and time to comply with the decision to issue stickers;
- No precedential support for the decision;
- The decision is impractical; and
- The decision violates the principle of equal treatment with other similar national credit card banks.

The liquidation of the credit card bank had been structured so that the buyer became the owner of the account and the issuer of credit to the account holder. However, the ownership of the actual plastic credit card remained with the original credit card bank. Upon expiration and renewal the buyer would then issue the account holder a new credit card. A notice conveying the sale of the ownership of the credit card accounts was sent to all cardholders at the time the portfolio was sold. The notice did not disclose the ownership of the plastic credit card.

Discussion

A key area of concern in this appeal involved the liquidation of the credit card bank. In reviewing the facts surrounding this appeal, the retention of ownership of the plastic credit cards by the credit card bank became the overriding regulatory concern because a liquidated entity cannot own assets. Options were explored on how the bank could resolve this issue without having an adverse impact on the involved parties.

Conclusion

In order to arrive at a feasible option to address all the issues involved, the ombudsman decided on the following course of action:

- The credit card bank should sell the plastic credit card ownership to a third party (either another affiliated entity or to the buyer) for a nominal fee.
- The credit card bank should notify all account holders of the new plastic credit card ownership. This notification would also contain information about future re-issuance of expired cards by the buyer.

These actions facilitated the liquidation of the credit card bank since the bank would no longer have ownership of the plastic credit cards. The disclosure provided customers with information regarding the card ownership and when new cards would be issued, therefore alleviating the need for issuing stickers.

Appeal of Noncompliance with Two Articles in a Formal Agreement

Background

A bank appealed the OCC's conclusions contained in the Report of Examination (ROE) regarding the bank's compliance with two articles in their formal agreement. Specifically, bank management disagreed with the OCC's noncompliance determination with articles focusing on loan administration and criticized assets.

The appeal was based on the following:

Loan administration

The article required the board to, within 60 days, develop and implement a written program to improve the bank's loan administration. A copy of the program was to be forwarded to the assistant deputy comptroller (ADC), along with a copy of the revised job descriptions and policies and procedures. The article also required the board to ensure that the bank had processes, personnel, and control systems to ensure implementation of and adherence to the program developed pursuant to this article.

The report of examination (ROE) noted noncompliance with this article because of a number of relationships with credit and collateral documentation exceptions, while noting that the framework had been established to improve the administration of the portfolio. The ROE further stated that achieving full compliance with this article is negatively affected by the continuation of the newly hired management's education of the existing customers and review of the existing relationships.

The bank appealed the conclusion on the level of compliance with this article because the bank was doing all that was required. The assistant deputy comptroller had been forwarded a copy of all adopted policies and procedures. Moreover, the bank has put in place and is implementing the systems to ensure compliance with these policies and procedures.

Criticized assets

The article required the bank to take immediate and continuing action to protects its interest in those assets criticized in the ROE, in any subsequent ROE, by internal or external loan review, or in any list provided to management by the bank examiners during any examination. Within 60 days the board was to adopt, implement, and thereafter ensure bank adherence to a written program to eliminate the basis of criticism of assets noted in the ROE, in any subsequent ROE, or by any internal or external loan review, or in any list provided by the bank's examiners during any examination as "doubtful," "substandard," or "special mention." A copy of the adopted program for all criticized assets equal to or exceeding $100,000 was to be forwarded to the ADC. The article also required the board to ensure that the bank has processes, personnel, and control systems to ensure implementation of and adherence to the program developed pursuant to this article. Other requirements included a quarterly review of the criticized assets, a submission to the ADC of these quarterly reviews, and the establishment of a committee to review loan activity involving these credits.

The ROE noted noncompliance with this article because the supervisory office, while recognizing the bank's efforts and results thus far, could not assess the bank's adherence to the criticized assets initiatives.

The bank appealed the conclusion on the compliance level of this article because the bank board had adopted and implemented plans to eliminate the basis of criticism for each of its problem loans. The appeal submission also stated that the board realized that compliance with this article would be judged on an ongoing basis.

Discussion

OCC's Policy and Procedures Manual (PPM) 5310–3 (REV), "Bank Supervision Operations—Enforcement Action Policy," provides internal OCC guidance for assessing compliance with enforcement actions. The PPM states that a rating of compliance can only be achieved on a particular article if the bank has adopted, implemented, and adhered to all of the corrective actions set forth in the article; the corrective actions are effective in addressing the bank's problems; and OCC examiners have verified through the examination process that this has been accomplished. It also states that a bank should not be considered in compliance with an article in an enforcement document simply because they have made progress or a good faith effort toward complying with the article.

The PPM further states that articles for which a bank has not achieved compliance include those articles where the bank has adopted and begun the implementation of all of the corrective actions required by the article, but sufficient time has not passed to verify that the actions have been fully implemented, are being adhered to, and are effective in addressing the bank's problems. In these situations, there is nothing additional for management and the board to do other than fully implement, adhere to, and assess the effectiveness of the corrective actions.

Conclusion

Both articles in the bank's formal agreement contain the following paragraph that requires not only the implementation of, but also the adherence to, the developed program under each of the corresponding articles:

> The Board shall ensure that the Bank has processes, personnel, and control systems to ensure implementation of and adherence to the program developed pursuant to this Article.

Bank management had taken appropriate action to implement the policies and procedures to comply with these two articles. However, at the time of examination, given the relatively short time since implementation, the supervisory office could not assess the bank's *adherence* to the loan administration and criticized assets initiatives. Therefore, it was concluded that the supervisory office's assessment of noncompliance with articles, at the time of the examination, was appropriate and consistent with OCC's "Enforcement Action Policy."

Composite and Component CAMELS Ratings

Appeal of 4 Composite CAMELS Rating and Various Component Ratings

Background

A bank formally appealed the bank's composite CAMELS Rating of 4 and each of the component ratings. The bank's ratings were:

- Capital component rating of 4;
- Asset Quality component rating of 4;
- Management component rating of 4;
- Earnings component rating of 5;
- Liquidity component rating of 4; and
- Sensitivity to Market Risk component rating of 4.

Management believed that the report of examination also had an unjustified negative bias and in some specific areas contained misleading statements. Bank management stated their performance in the past and in the current situation did not demonstrate the characteristics of a 4-rated bank as described in Banking Circular 97–1, "Uniform Financial Institutions Rating System." They felt that the CAMELS ratings were the result of a political issue that motivated the OCC to "paint" their bank as a poor performer.

The bank's report of examination concluded that the bank's overall condition was unsatisfactory with serious financial and managerial deficiencies noted. The bank's assets grew significantly between examinations through the origination or purchase of a certain type of loan product to support a securitization activity. Unwinding of the accounting of these securitizations and rebooking of securitized loans also added significantly to the bank's balance sheet. This growth was funded by high cost brokered deposits. Current holdings of this type of loan product were at unsafe and unsound levels and had to be reduced. Management had not been able to sell these loans in an expedient manner at desired prices. The large concentration exposed earnings and capital to unacceptable levels of instability and risk and threatened the bank's ability to withstand business fluctuations. The reversal of the accounting treatment for these securitizations caused the bank to suffer losses. Earnings were insufficient to support capital. Interest rate, liquidity, and compliance activities also demonstrated significant weaknesses.

Discussion

OCC Bulletin 97–1, "Uniform Financial Institutions Rating System," states that the evaluation of the component ratings take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile. While the composite rating generally bears a close relationship to the assigned 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 facts comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution.

During and after the examination, the bank took aggressive action in correcting many of the deficiencies noted in the report of examination. These included a significant capital injection and successful reduction of their significant exposure in the particular type of loan product without significant losses to the bank.

Conclusion

After a thorough review of the examination findings and discussions with bank management, the ombudsman concluded that the examination process was not efficiently managed and should have been more balanced; however, the OCC's supervisory conclusions were not out of context in light of the:

- Uncertainty and unknown factors regarding the bank's ability to reduce the significant exposure in a particular type of loan product,
- Potential impact of this exposure on the other areas of the bank, i.e., capital, earnings, liquidity; and
- Other risk management concerns.

Therefore, the ombudsman did not change the assigned ratings.

Appeal of a Loan Classification and the Earnings and Management Component Ratings

Background

A bank formally appealed the supervisory office's loss classification of an investment in a particular business trust. The bank also appealed the 3 rating assigned to the earnings and management components in the ROE. Management believed that the downgrade of these components was primarily driven by the loss classification of the investment.

The ROE stated, "the bank's investment in the trust was imprudent and reflects unsafe and unsound investment practices. Management and the board did not perform adequate due diligence prior to purchasing this asset. Management's pre-purchase analysis did not adequately address the significant inherent risks in this investment." The ROE concluded that the bank's investment in the trust is a non-bankable asset and was classified loss for the following reasons:

Credit risk is high because:

- The trust is a new entity with no established operating history;
- Repayment period is protracted;

- Timing and amount of payments are uncertain;
- The beneficial interest is last in priority of payments; and
- Ultimate residual value is unpredictable.
  - The asset is long-term and predominantly speculative in nature.
  - The asset is below investment quality and is not marketable.

The bank disagreed with the loss classification for reasons that included the following:

- Subsequent purchasers have paid a slightly higher price than the price paid by the bank.
- This type of transaction is commonplace in banking.
- The credit risk is spread among the collateral and other involved parties to this transaction.
- The co-investors and managers of the trust are top of the line experts in their field.
- The estimated residual proceeds versus the carrying value of the asset.
- The trust is now generating positive cash flow sufficient to service debt ahead of schedule.

Discussion

The federal bank and thrift regulatory agencies currently use the following definitions for assets classified "substandard," "doubtful," and "loss" for supervisory purposes:

> *Substandard assets*—A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
>
> *Doubtful assets*—An asset classified as doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.
>
> *Loss assets*—Assets classified as a loss are considered uncollectible and of such little value that there continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

The trust is a special-purpose business trust established to purchase, own, lease, and sell a certain type of equipment. The bank's investment represents a beneficial interest in the residual component of the transaction. The beneficial interest entitles the bank to a share of any residual proceeds after payment in full of all interest and principal on the debt.

The characteristics of the transaction include:

- An infrastructure which provides for:
- Annual certified financial statements,
- Annual appraisal of the equipment from three independent sources, and

- A built-in reserve.
- The value of the underlying collateral.
- Tax benefits to be received for two years.
- Reputation of the servicer.
- Positive financial performance for the first 12 months of operation.

After thoroughly reviewing all facets of the asset, the following well-defined weaknesses were identified:

- The repayment period is protracted.
- Residual proceeds (principal repayment) will not be received until 2016 at the earliest, and potentially not until 2024.
- Although the bank will receive tax benefits in 1999 and 2000, it is not repayment of principal. Reinvestment of this tax benefit will still result in an extended period for principal recovery.
- The timing and amount of payments are uncertain. The bank's beneficial interest in the transaction is in last position for the priority of payments. There are five classes of debt that take priority over the residual interests.
- The ultimate residual value is unpredictable. There are variables that could affect the adequacy of cash flow through the life of the transaction, such as changes in interest rates and events that could diminish the value of the equipment.
- Residual interest is below investment grade quality.

Conclusion

These well-defined weaknesses, discussed above, reflect an increased level of risk indicative of a substandard asset. Therefore, the ombudsman concluded that a substandard classification was more appropriate. The bank was instructed to monitor the value of this asset on at least an annual basis, recognizing any impairment in value, in accordance with GAAP guidance.

Earnings (Rated 3)

Discussion

The earnings rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability of quality earnings. A rating of 2 indicates earnings that are satisfactory to support operations and maintain adequate capital and allowance for loan levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

Conclusion

In view of the change in classification of the above investment, the ombudsman concluded that a 2 rating was more reflective of the earnings posture of the bank.

Management (Rated 3)

Discussion

The component management rating reflects the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risk of their institution's activities and to ensure that the financial institution is safe, sound, and that it efficiently operates in compliance with applicable laws and regulation. The management rating of 3 indicates management and board performance that needs 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.

Conclusion

While the investment classification was changed, the issues of suitability, due diligence, and risk management noted during the examination remain. However, while the investment decision was a factor in the assessment of the management rating, the rating was also based on a number of other factors that need enhancement. These included credit administration, compliance operations, and other risk management practices that were detailed in the report of examination. Therefore, the ombudsman concluded that a management rating of 3 was appropriate at the time of the examination.

Appeal of Component and Composite Ratings and ROE Conclusions regarding the Internal Audit Process and the Custody Arrangement

Background

A national bank formally appealed the following:

- The Composite Uniform Financial Institutions rating of 3, and the conclusion that the overall condition of the bank was less than satisfactory.
- The ROE conclusions relating to capital adequacy, earnings, liquidity, sensitivity to market risk, and the internal audit process.
- The ROE conclusion that the level of supervision by management and the Board was less than satisfactory, i.e., management rating.
- ROE conclusion pertaining to a certain custodial arrangement.

The appeal highlighted the bank's position on each of the individual component ratings, the internal audit process, the composite rating, and the custody arrangement. In this appeal summary, the discussion and conclusion on each of the appealed component ratings and internal audit issues will be discussed individually, followed by an overall discussion and conclusion on the composite rating and the custodial arrangement.

Discussion and Conclusion

Capital—*Report of Examination Rating 3*

The appeal stated that with its existing capital ratios the bank was "well-capitalized," yet the OCC concluded that capital was unsatisfactory. The appeal further stated that this was inappropriate because the OCC should have realized that the bank's capital position would improve in the coming months with planned reductions in certain exposures. According to the bank, the OCC seemed to base its conclusions on the bank's recent rate of asset growth and on comparisons with the bank's peers, not on the established regulatory benchmarks for measuring capital adequacy.

A financial institution is expected to maintain capital commensurate with the nature and extent of its risks and management's ability to identify, measure, monitor, and control these risks. The bank's risk profile increased primarily due to rapid asset growth and a large concentration of exposure in high-risk emerging countries. At the time of the examination, the bank's criticized assets doubled, earnings performance was only fair, and weaknesses were noted in the allowance for loan and lease losses (ALLL) methodology, loan administration, and operations. While the bank's capital and strategic plans called for continued growth, efforts to increase capital had not been successful. Although the bank met the prompt corrective action (PCA) benchmark ratios, there were significant qualitative factors that supported the need for additional capital. The capital posture did not fully support the bank's risk profile, even though the quantitative ratios exceeded the minimum statutory requirements. Therefore, the ombudsman concluded that the assigned 3 rating was appropriate at the time of the examination.

Management—*ROE rating 3*

The appeal stated that the OCC's view that management and the Board did not adequately supervise the bank was based on a faulty two-pronged analysis. First, it incorrectly assumed that the bank's overall condition was less than satisfactory. Secondly, it rested on two events that occurred at the bank, the increase in an emerging market exposure and a certain custodial arrangement. The appeal stated that neither of these events was indicative of lax supervision at the bank.

The management rating reflects the quality of board and management supervision of a bank. Management practices differ depending on the size and complexity of the organization. Risk management practices and controls should be commensurate with the bank's risk profile and complexity. The ability and willingness of management to respond to changing circumstances and to address risks that may arise from changing business conditions in a timely manner are important factors in determining the management rating. The ombudsman recognized the tenure and experience of the management team and the board; however, at the time of the examination, management had not implemented risk management processes to adequately identify, monitor, and control risk in key areas of the bank, such as capital, liquidity management, concentrations, and supervision of affiliate activities. The ombudsman concluded that at the time of the examination, the assigned 3 rating was appropriate.

Earnings—*ROE rating 3*

The appeal indicated that earnings were stable, and that prior to agreeing to record an almost $2 million ALLL provision against 1997 earnings, the bank's return on equity would have been in excess of 13 percent and its return on assets would have been 0.68 percent.

Pursuant to OCC Bulletin 97–1, "Uniform Financial Institutions Rating System and Disclosure of Component Ratings," the earnings rating reflects not only the quantity and trend of earnings, but also factors in events that may affect the sustainability or quality of earnings. Earnings should be sufficient to support operations and to provide for the accretion of capital and adequate provisions to the ALLL. The bank's 1997 earnings performance was sufficient to support operations and the ALLL, but capital augmentation was minimal considering the bank's growth. Trends noted in lower asset yields, higher deposit costs, and increased provisions were factored into the analysis. Based on this, the ombudsman concluded that a 3 rating was appropriate, at the time of the examination.

Liquidity—*ROE Rating 3*

The appeal indicated that the OCC's 3 rating was based on a set of contingencies that are highly unlikely to occur. The bank does not believe that they are at risk of losing their ability to attract brokered deposits; its principal source of funding. The appeal also stated that the bank has access to substantial sources of stable capital that could and would be utilized if its ability to accept brokered deposits were in jeopardy.

The bank has high liquidity risk based on its capital position and the increased risk resulting from the bank's exposure in some of their emerging markets portfolios. In addition, the bank did not have an adequate contingency funding plan should its eligibility for brokered deposits become jeopardized. Based on these factors, the ombudsman determined that a 3 rating appropriately reflected the bank's liquidity posture at the time of the examination.

Sensitivity to Market Risk—*ROE rating 3*

The appeal stated that the 3 rating was assigned solely on the basis of a certain foreign country exposure. The ROE stated that interest rate and foreign exchange risks were considered low at the time of the examination and that the rating was assigned based on the foreign country exposure. The ombudsman concluded that a 2 rating was more reflective of the condition of this area, at the time of the examination rather than the assigned 3 rating.

Internal Audit Process

The appeal stated that the bank's internal audit process was considered less than satisfactory by the OCC because the audit schedule had not been completed and that the bank's audit committee had not met from late 1996 through mid-1997. The appeal also discussed a number of events occurring in early 1997 which adversely impacted on the internal audit function. The appeal stated that there were no negative repercussions in the bank during the period in which the events occurred.

While the ombudsman acknowledged the bank's arguments regarding the various audit function weaknesses noted in the ROE, there was need for improvement. Particularly, in light of the high operational risks noted in certain areas, such as in Treasury. Although some weaknesses, individually, could have been mitigated by unplanned events that occurred during the examination, collectively, they posed a concern that warranted management and the board's attention. OCC Bulletin 98–1, "Interagency Policy Statement on Internal Audit and Internal Audit Outsourcing" (January 7, 1998), states in part that "In discharging their responsibilities, directors and senior management should have reasonable assurance that the system of internal control prevents or detects inaccurate, incomplete or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial and regulatory reporting; and deviations from laws, regulations, and the institution's policies. . . . Directors should be confident that the internal audit function meets the demands posed by the institution's current and planned activities."

Bank management indicated to the ombudsman that most of these audit deficiencies had been corrected subsequent to the examination.

Composite Rating (ROE Rating 3) and Summary

The bank's appellate submission stated that based on the bank's discussions of the component ratings, its overall condition during the period covered by this examination was not less than satisfactory. The appeal indicated that many of the conclusions in the ROE were reached with no factual or other evidentiary support. It further stated that the conclusions were inconsistent with the true condition of the bank and seemed designed to serve a justification for the 3 rating, rather than an accurate description of the bank's condition.

The OCC Bulletin 97–1, "Uniform Financial Institutions Rating System," states:

> Financial institutions . . . [rated 3] exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. . . . Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions. *[Fed. Reg.:* December 19, 1996, Vol. 61, No. 245, p. 67026]

At the time of the examination, the bank exhibited a significant degree of supervisory concern because of its rapid growth, increased exposure in particular emerging markets, and their impact on the bank's capital, earnings, and liquidity positions. Furthermore, the bank had not implemented risk management processes to adequately identify, monitor, and control risk in key areas of the bank, such as capital, liquidity management, concentrations, and supervision of affiliate activities. Based on this, the ombudsman determined that the 3 composite rating was reflective of the condition of the bank at the time of the examination. Additionally, these adverse trends and concerns continued through the processing of this appeal.

Custody Arrangement

The bank also appealed the OCC's conclusion that a custodial arrangement between the bank and its foreign affiliate constituted an unsafe and unsound banking practice and a violation of section 23B of the Federal Reserve Act, 12 USC 371c-1. The appeal states that while the custody arrangement with its affiliate could have been better documented and administered, it did not constitute an unsafe and unsound banking practice and did not result in a violation of law as noted in the ROE. The ombudsman reviewed this issue and carefully considered the points of discussion in the appeal and in the bank's outside counsel's letter.

Although banking is characterized by risk-taking, this arrangement reflected characteristics that were not prudent banking practices. For example:

The bank's sole purpose for entering into an agreement was to inflate the affiliate's balance sheet.

The bank participated in a repurchase agreement with little direct knowledge of the foreign country's central bank custody and control practices and had to rely on the counterparty for the expertise.

The officer normally responsible for administering custody and similar arrangements was unaware of the agreement and related accounts.

The board was not notified of this agreement, even though they had been previously served with civil money penalties for similar transactions.

No one from the bank had signed the agreement.

The bank did not maintain records or statements to track and report proceeds from any of the account transactions, other than original wires between the bank and its affiliate.

Furthermore, the ombudsman determined that the arrangement was not "on terms and under circumstances that in good faith would be offered to, or would apply to, nonaffiliated companies." Therefore, the ombudsman concluded that the custody arrangement was an unsafe and unsound practice and violated section 23B of the Federal Reserve Act, 12 USC 371c–1.

Appeal of Composite CAMELS Rating of 3 and "Needs to Improve" CRA Rating

Background

A bank formally appealed the 3 management rating and the 3 composite rating assigned in its most recent ROE. Senior management and the board believed the ratings were incorrect based on the following:

- Inappropriate characterization of matters requiring board attention (MRBA) as a repeat criticism; and
- Inappropriate criticism of the new product development process, when the bank had not yet to incur any exposure from these new products.

The bank also appealed the CRA rating of "Needs to Improve." The bank noted that rating was based on:

- A low percentage (22 percent) of the bank's lending in its assessment area, and
- A small percentage of the bank's lending to businesses of different sizes, 16 percent of the bank's commercial loans were to small businesses and 27 percent of the loans were of a loan amount less than $100,000.

The bank concurred with the percentages arrived at, but disagreed with the individual component ratings assigned to "Lending in the Assessment Area" and "Lending to Borrowers of Different Incomes and to Businesses of Different Sizes." Senior management of the bank believed the statistics were reasonable when their business strategy was taken into account. The appeal also noted the bank's prior CRA rating was "Outstanding."

Factual Errors

The appeal submission detailed what management believed were five factual errors in the ROE:

- The statement that the increase in nonaccrual loans was due to an OCC examination finding.
- The statement that qualitative factors are not used in the ALLL, and that management does not review changes in the composition of classified assets in analyzing the ALLL.
- The statement in the ROE that financial statement spreads are incorrect, and that debt service coverage analysis has been frequently manipulated to show coverage in the best possible light.
- The MRBA reflected as repeat criticisms.
- The recommendation to formalize the new product process to include comprehensive and formalized risk analysis.

Increase in Nonaccrual Loans

In the appeal, bank management objected to the bank initiated increase in nonaccrual loans being reflected as OCC adjustments. Once an examination has commenced, it is OCC procedure to reflect all loan status changes in the examination conclusions. If the changes were a result of management action, it is appropriate to reflect that management initiated the changes, but this does not preclude the changes from being reflected as part of the examination conclusions.

Analysis of the Allowance for Loan and Lease Loss

Comments in the ROE indicated management had not been using qualitative factors to estimate inherent loss in the Pass portion of the loan portfolio, such as changes in the volume and severity of past due and classified loans. The appeal stated the bank has been utilizing a dual methodology for reviewing the adequacy of the ALLL. The bank's methodology included a comparison to an independent benchmark and using the format outlined in Banking Circular 201 (including consideration of qualitative factors); and have used this methodology for several years. The appeal stated that for the past two years regulators and the independent public accountant had accepted the bank's methodology without criticism. Based on these comments, management determined that the comment in the ROE indicating the bank does not use qualitative factors was incorrect. The ombudsman's review of the work papers determined that the supervisory office adjustments focused on two portfolios that experienced 22 percent growth and were planned for additional 50 percent growth going forward. ROE comments did not clearly reflect the concern with the limited use of qualitative factors to determine the adequacy of the ALLL.

Inaccurate and Manipulation of Financial Statements

The appeal stated that the ROE comments regarding material errors in financial statement spreads were incorrect. The ROE recommended the establishment of quality control over the accuracy of financial statement spreads. It also stated that loan review had found material errors in approximately 25 percent of cash flow statements. The appeal states that the bank uses a computer-generated spread package that is not changeable by the credit analysts; however, errors have been made in the manual conversion from the standardized spread information into a proprietary risk screening tool. Management and the Board were aware of these errors. While, the ombudsman concluded that the statement on the accuracy of the financial statement spreads was incorrect, the issue of making decisions on erroneous financial information is cause for concern.

Repeat Matters Requiring Board Attention

The appeal also noted that the OCC examination team listed MRBA as repeat criticisms from the previous ROE. The board and management disagreed with this characterization and provided a listing of MRBA from both examinations to illustrate their posture on this issue. The board and management were correct in noting that there was only one repeat MRBA detailed in the examination being appealed; however, weaknesses were again identified in lending, which is the bank's most significant activity. The lending area had been the subject of MRBA in the last three ROEs.

New Product Development Process

One of the issues contained in the MRBA dealt with the bank's need to formalize a new product process. The appeal noted that at the time of the examination the bank was just beginning to underwrite its first live transaction in the new financing program and found it necessary to alter some procedures because the actual information was different than anticipated. The bank acknowledged their interest as an innovator and advocate for new products. They also maintained that there were no loans outstanding in any new product category and the highly critical focus by examination team to new products in the ROE was inappropriate.

The ability of management to respond to and address the risks that may arise from changing business conditions, or the initiation of new activities or products is an important factor in determining the overall risk profile of the bank. This institution had a history of being innovative in developing new products. The ombudsman determined, while the bank had not booked any new products at the time of the examination, a *formalized* new product process, whether there was exposure booked or not, was a sound recommendation for this organization, given their appetite for product innovation.

Management Rating

Background

The appeal submission states that the board and management's practices and performance were not less than satisfactory given the nature of the bank's activities. The submission lists the following items as significant changes that have occurred since the last examination:

- Significant progress has been made in enhancing credit administration and controls;
- Successful execution of an initial public offering that trebled total capital in the bank; and
- The bank has demonstrated its ability to underwrite and service quality commercial loans by virtue of its success in capital market activities.

Discussion and Conclusion

The management rating is designed to reflect the quality of board and management supervision of the institution. Management practices differ depending on the size and complexity of the organization. Complex organizations require a stronger framework of systems and controls. Having gained an understanding of the complexity of the bank's activities and despite the size of the bank, the ombudsman determined activities in this institution required *formalized* systems and controls. Over the last three years, significant weaknesses in risk management systems and controls were detailed within ROEs. While management made significant progress in some areas, other areas lagged in implementation of appropriate processes to identify, measure, monitor, and control risks associated with the bank's activities. The ROE addressed several weaknesses in risk management systems associated with the bank's lending practices. The lending control weaknesses dealt with the lack of officer accountability for assigning risk rating and the volume of inaccurate risk ratings identified during the examination. The bank had a history of inaccurate officer ratings and lack of accountability.

OCC Bulletin 97-1, "Uniform Financial Institutions Rating System and Disclosure of Component Ratings" (January 3, 1997), reflects an increased emphasis on risk management processes, particularly in the management component. This bank's management team had experienced significant successes, which were highlighted in the appeal. However, risk management processes had not been commensurate with the complexity of their activities or development of new products. At the time of the examination, risk management activities needed strengthening to ensure problems or significant risks were adequately identified, measured, monitored, and controlled. The ombudsman determined the assigned 3 management rating was appropriate given the concerns regarding risk management systems.

Composite Rating

Background

The appeal stated the bank's composite rating was lowered from a 2 to a 3 rating, when the financial performance of the bank had strengthened. The bank provided a recap of financial indicators. At the last examination the bank's assigned C/CAMELS ratings were 2/233222, while at the appealed examination they were 3/233122. The appeal submission stated the only change from the prior examination was an improvement in earnings and that the capital rating arguably could have been 1 rated. Bank management also commented that subsequent to the examination, but well in advance of the issuance of the ROE, a substantial amount of capital was downstreamed to the bank, increasing the leverage ratio. In the board and management's opinion, the OCC should not have had any material supervisory concerns.

Discussion and Conclusion

The appeal, appropriately, discussed the financial performance of the institution. The strong capital base and level of earnings the bank generated certainly warrant consideration when assigning the composite rating. However, those areas by themselves are not the basis for determination of this rating. A composite rating should incorporate any factor that bears significantly on the overall condition and soundness of the institution. The ability of management to address the risks confronting an organization is an important factor in evaluating the overall risk profile and determining the level of supervisory attention. The board and management's lack of diligence in effectively addressing risk control functions detailed in previous ROEs, within appropriate time frames, was again demonstrated with three of the four MRBA identified in the examination under appeal focusing on this issue. As discussed above, the risk management concerns regarding the bank's lending activities have received specific attention in the last three ROEs. Left unchecked, these concerns have the potential to become more severe in an economic downturn, particularly because this bank's target market is the manufacturing sector. Therefore, the ombudsman found the assigned 3 composite rating appropriate, considering weaknesses in the bank's risk management systems.

CRA Appeal

Background

In the CRA appeal, the board and management stated that although they agree with the numerical analysis used to determine the CRA rating, the statistics are reasonable when the bank's business strategy and performance context is taken into account. Further, based on dollar volume of credit extended within the bank's assessment area, the bank has satisfactorily performed under the CRA regulations. The appeal noted the bank does not fit the profile of a typical community bank. It specializes in providing credit, trade and depository services to small and medium size manufacturing companies located in the United States and several international emerging markets. The bank's typical borrower is a privately owned and operated company with annual sales of $2–25 million, and has been in business for at least three years. The bank extensively uses government guaranteed loan programs and typically will sell either the entire loan or the guaranteed portion of the loan, while retaining servicing rights.

The bank accomplishes its business strategy through the operation of one full-service office and eight loan production offices (LPOs) throughout their geographic region of the country. In addition, the bank has contracts with 11 international agents located in the emerging markets of South America, Central America, Mexico, Middle East, Asia, South Pacific, and South Africa.

Discussion

Given the bank's business strategy and performance context, the key issue in this appeal was if the bank had satisfactorily met the credit needs of its community. The facts involved in this appeal are not in dispute. The supervisory office did not dispute, and indeed used in its evaluation of the bank's CRA efforts, the statistical analysis prepared by the bank's CRA officer. The "Needs to Improve" rating was based on the determination that the bank "Does Not Meet Standards for Satisfactory Performance" for two assessment criteria—"Lending in Assessment Area" and "Lending to Borrowers of Different Incomes and to Businesses of Different Sizes." Further, the "Loan to Deposit Ratio" and "Geographic Distribution of Loans" were found to "Exceed the Standards for Satisfactory Performance" and "Meet the Standards for Satisfactory Performance," respectively.

To reach a conclusion on this appeal, the ombudsman carefully considered the bank's business strategy and performance context to determine the impact on the bank's overall CRA assessment.

Performance Context

In evaluating a bank's CRA activities, a full understanding of the performance context in which it operates is necessary. The performance context considers the economic condition and demographics of the assessment area, competition, and the types of products and services offered by the bank. In the case of this bank's CRA evaluation, the performance context was an integral component of the ombudsman's analysis because of the unique business plan and product delivery systems employed by the bank. While the CRA activities of other similarly situated financial institutions are considered, bank-by-bank comparisons are not a component of the overall rating process.

Lending in Assessment Area

In general, an institution that does not originate more than 50 percent of its lending in its assessment area will not meet the standards for satisfactory performance. However, the significance of this factor may be mitigated when considering performance context issues such as, competition, economic conditions, a bank's product line, or business strategy. In addition, when an institution has a high level of lending outside its assessment area because of the use of non-traditional product delivery systems, favorable consideration may be given for loans to LMI persons and for small businesses and farm loans that are made outside the assessment area, provided the institution has adequately addressed the needs of its assessment area.

During the CRA evaluation period, the bank originated 16 percent of its loans within its assessment area and 84 percent of its loans outside its assessment area. In addition, only 22 percent of the total number of loans originated during the evaluation period were made within the bank's assessment area. The bank's business strategy of selling either whole loans or the guaranteed portion of loans, allowed it to provide significantly more small business credit than it could using a more traditional approach. This strategy enabled a $200 million dollar bank to originate almost $500 million in loans during the two-year evaluation period. In terms of total small business lending, as reported to the FFIEC, the bank compares favorably to two large banks in the area and to the average per bank data. In 1996, the average reporting bank in the state originated $12 million in small business loans, while this bank originated more than $37 million.

While lending in the bank's assessment area in dollar terms is favorable, the ratio of total lending inside versus outside of the assessment area is less than 50 percent. However, it is clear that the loans made outside of the assessment area through the LPOs are consistent with the bank's business strategy. Even though lending in the bank's assessment area technically does not meet the standards for satisfactory performance, this factor should not negatively impact the evaluation of the bank's overall CRA performance. Therefore, while the ombudsman did not change the conclusion for this factor, it was determined that the impact of not meeting this standard should be mitigated on the overall CRA evaluation when the performance context is considered.

Lending to Borrowers of Different Incomes and to Businesses of Different Sizes

Under the small bank CRA procedures, commercial lending performance is evaluated based on the number and volume of loans to businesses of different sizes. Loans made to businesses with revenues less than $1 million are considered small business loans under the CRA regulation. When sufficient data is not available to analyze these assessment criteria, examiners may consider loans that were less than $100 thousand when originated, as a proxy for business size.

During the CRA evaluation period, the bank originated 8 percent by dollar amount and 16 percent by number of the loans in the assessment area to businesses with gross annual revenues of less than $1 million. While approximately 39 percent of the average bank's small business loans are to businesses with gross annual revenues of less than $1 million, this bank only made 11 percent of its small business loans to such businesses. In addition, 14 percent of the small business loans the average bank originates are less than $100 thousand, compared with this bank's 5 percent.

Community contacts within the bank's assessment area identified the need for micro-loans and start-up loans to small business owners. By targeting borrowers with gross annual revenues between $2–25 million, the bank limited its ability to meet the credit needs of very small business owners. Strict adherence to the business strategy limits the bank's ability to meet these needs of their community.

Therefore, when considering all relevant facts and circumstances, the ombudsman concurred with the findings of the supervisory office that the bank does not meet the standards for satisfactory performance under this factor.

Conclusion

Based on the available data, the ombudsman concluded that the bank's CRA performance for the evaluation period was more reflective of a "Satisfactory Record of Meeting the Community's Credit Needs" than the assigned "Needs to Improve." While "Lending in the Assessment Area" did not meet the standards for satisfactory performance, the bank's business strategy, product line, and performance context issues mitigated the impact of this conclusion on the overall CRA rating. This coupled with the positive conclusions for the "Loan to Deposit Ratio" and the "Geographic Distribution of Loans" further supports an overall performance rating of "Satisfactory Record of Meeting the Community's Credit Needs." The rating for "Lending to Borrowers of Different Incomes and to Businesses of Different Sizes" remains unchanged.

Appeal of Composite CAMELS Rating of 3 and Other Examination Conclusions

The board of directors (the board) appealed, on behalf of the bank, several matters in the ROE. The appeal centered on three "loss" loan classifications that were directed for charge-off retroactive to year end. The bank disagreed with both the timing and the charge-off of these loans.

The bank also appealed the following related matters:

- The composite rating and the component ratings for capital, asset quality, management, and earnings;
- The restatement of the year end Call Report;
- Four resulting violations of law—three violations of 12 USC 84 and one violation of 12 USC 60(b);
- The assessments for credit, compliance, strategic, and reputation risks; and
- The proposed formal agreement.

The loans were carryover agricultural debt. To evaluate the credit quality of the three loan classifications challenged in the appeal, consideration was given to information available during the examination and the supplemental information provided by bank management, when warranted. This supplemental information consisted of current collateral valuations. Additionally, the ombudsman discussed the operating status of the three credits with bank management. Finally, the guidance in " OCC Examining Circular 222: Agricultural Loan Classification" regarding carryover debt was also considered in reaching the conclusions in this appeal.

Classification of Credits

Borrower 1

(ROE Classification: $114 thousand—Loss)

Background and Discussion

The first borrower had a history of poor operating performance. Over the last six years the borrower generated $150 thousand in carryover debt and paid only $36 thousand toward the reduction of carryover balances resulting in outstanding debt of $114 thousand. Bank management did not fund the current year's operating expenses, but the borrower was being financed by another institution. The borrower's cash flow projections reflected profitable operations for the current season after servicing all debt, including a portion of the bank's carryover debt and accrued interest. However, the borrower had a poor history of meeting projections. Bank management used more conservative estimates in their projections that reflected a small shortfall in the borrower's ability to meet all debt service requirements.

Equipment securing the loan was not supported by an independent valuation and, therefore, not given consideration during the examination. Subsequently, management obtained an independent auctioneer's valuation of the equipment, totaling $89 thousand. Also, $8 thousand in notes receivable were assigned to the bank. The total value of the collateral securing the carryover debt was $97 thousand compared to an outstanding balance of $114 thousand.

Conclusion

The ombudsman determined a doubtful classification was appropriate for borrower. The loans were appropriately placed on nonaccrual as of year-end 1997 because full payment of principal and interest was in doubt. Classifying the credit doubtful recognized that, while bank management did not increase their exposure, they could benefit from the borrower's 1998 crop, as reflected in the two cashflow projections.

The ombudsman decided a dollar amount equal to the unsecured portion of this credit should be specifically allocated for in the ALLL and the secured portion of the debt should have allocations based on the bank's formula for this risk category. Any payments received were to be applied to the oldest carryover balances.

If the borrower has another unsuccessful year of operation and is unable to meet debt service requirements, the debt should be charged-off. This should occur no later than March 31, 1999.

Borrower 2

(ROE Classification: $67 thousand—Loss)

Background and Discussion

The second borrower was no longer actively farming because of unprofitable farm operations and had been making payments from liquidation of the farm equipment that serves as collateral on the carryover debt. The borrower's payment history revealed that the last principal reduction occurred seven months prior to the examination. During the examination, payments totaling $10 thousand were made, which management applied to interest. While the supervisory office considered the principal reduction, they were unaware payments had been made during the supervisory activity.

During the examination, bank management inspected the equipment and estimated its value at $75 thousand and the hay at $8 thousand, although the hay is not collateral for the bank's debt. The borrower's estimate of value for the same equipment list totaled $151 thousand. Subsequent to the examination management received a written cash offer of $25 thousand for a portion of the collateral, compared to the borrower's value of $74 thousand for the same equipment. The offer included an additional $3 thousand for the hay.

The borrower has unencumbered real estate that is available for sale. The borrower had expressed, in writing, his intent to apply the proceeds from the sale of the real estate to his bank debt. He had received a verbal offer on one parcel for $32 thousand; however, this included a portion of the equipment (irrigation-related) in the cash offer discussed above.

Conclusion

The ombudsman determined a split classification of substandard ($28 thousand) and doubtful ($29 thousand) appropriately recognized the risk associated with this credit. The loans should have been placed on nonaccrual as of year-end because full payment of principal and interest was in doubt. The $10 thousand of interest payments made during the examination was inappropriate.

The ombudsman directed bank management to reverse the interest and apply the payments to principal. The classification was based on:

- The borrower's demonstrated willingness to repay his debt from the liquidation of the collateral, evidenced by the payments made in 1998;
- The bank's written cash offer of $28 thousand for a portion of the equipment and hay;
- The value of the remaining collateral is questionable; and
- Although other assets are available, the bank has no collateral interest in them.

The substandard classification represents the cash offer for a portion of the equipment. The doubtful portion of the credit recognizes the difference in value between the cash offer and the outstanding balance after the reversal of interest payments. This also considered bank management's position, that the borrower will apply proceeds from the sale of the remaining equipment and/or real estate. Land sales are best realized during the non-growing season from late November to March. Management was informed to make ALLL allocations according to the bank's formula for these risk categories. If the loans are not repaid by March 31, 1999, they should be charged off and appropriate recovery methods instituted.

Borrower 3

(ROE Classification: $65 thousand—Loss)

Background and Discussion

On the third borrower the bank had a lien on irrigation equipment valued by the borrower in January 1993 at $109 thousand. As the equipment is attached to the land, management had demonstrated a reluctance to initiate repossession procedures. The borrower was uncooperative, with extremely past-due debt that had a questionable repayment source and lacked a current collateral valuation.

Conclusion

Based on the above, the ombudsman's office agreed with the examiners that the debt was a loss. The undeterminable collateral values and protracted collection period made the loans of such little value that their continuance as bankable assets was not warranted.

Effect of Loan Classification Change

The ombudsman requested appropriate members of the bank's management team and members from the OCC's supervisory office meet to determine the impact of the reclassification of two of the three credits on the violations of law and the bank's balance sheet. The ombudsman asked that a written summary of any changes be provided to his office.

Risk Assessment System Conclusions

There was agreement on several risk categories; therefore, the ombudsman only addressed the four risk categories in which the board expressed a difference from the assessment in the ROE. Those risk categories were credit, compliance, reputation, and strategic. The following comments provide the basis for the decisions on those risk categories.

Credit Risk

Credit risk was assessed as *high and stable* at the time of the examination. The appeal stated that it should be *moderate and stable*. The volume of problem credits was significant and the trend was increasing. Credit-related losses necessitated abnormally high provisions to the ALLL to cover inherent losses. Significant concentrations of credit exist in the form of agricultural and unsecured loans. Credit analyses were not comprehensive and there were weaknesses in collateral controls. The ombudsman determined that collectively, these characteristics were indicators of a high level of credit risk.

Compliance Risk

Compliance risk was assessed as *high and increasing* at the time of the examination. The appeal stated that it should be *moderate and stable*. The bank's history of violations since 1990 was low, consisting of a few consumer protection and Bank Secrecy Act citations. The volume of violations at the examination under appeal was centered in one area (lending) and dependent on three loan classifications. However, these violations were more substantial and representative of moderate compliance risk. The bank's overall compliance program had been effective in the past in detecting, correcting, and preventing frequent violations. Based on this, the ombudsman decided the direction of compliance risk was stable.

Reputation Risk

Reputation risk was assessed as *moderate and stable* at the time of the examination. The appeal stated that it should be *low and stable*. Considering the potential negative public response or perception from the large volume of loan losses and related recovery actions, the ombudsman determined reputation risk was moderate.

Strategic Risk

Strategic risk was assessed as *moderate and increasing* at the time of the examination. The appeal stated that it should be *moderate and stable*. There was no evidence to suggest the bank's strategic initiatives would alter business plans or that they were inconsistent with the existing line of business. Therefore, the direction for strategic risk was determined to be stable.

Component and Composite Ratings Conclusions

Capital Rating

Capital was rated 3 in the ROE. The appeal stated that it should be rated 2. The bank's level of capital did not provide the necessary base to support its current lending activities. Management is forced to sell participations on large agricultural borrowers because of the reduced legal lending limit. Earnings have not been sufficient to provide for adequate capital accretion because of the large provision expense required to replenish the ALLL. In addition, the volume of problem assets continued to strain the bank's level of capital. Based on these factors, the bank's capital was less than satisfactory for its risk profile and warranted a 3 rating.

Asset Quality Rating

Asset quality was rated 3 in the ROE. The appeal stated that it should be rated 2. The bank's credit quality had deteriorated, evidenced by the increasing trend in problem assets. While the bank operates in an agricultural-based economy that can be affected by the weather, ineffective credit administration practices had contributed to the deterioration in credit quality. There was a need to improve credit administration practices in the following areas:

- Developing action plans for problem borrowers:
- Using comparative analysis on borrowers' performance to projections; and
- More detailed analysis to support borrowers credit worthiness for unsecured lending.

The current level of problem loans, deteriorating trends in asset quality, and weaknesses in credit administration practices provided support for the 3 rating assigned to asset quality.

Management Rating

Management was rated 3 in the ROE. The appeal stated that it should be rated 2. Safety and soundness ROEs from 1994, 1995, and 1996 revealed management had made progress in several areas where there was supervisory concern. However, there was a need to improve credit administration practices and reverse the increasing trend in problem assets. The weaknesses in the bank's credit culture and processes continued to plague the overall performance of the bank with significant loan losses, high provision expenses, erratic earnings fluctuations, and minimum capital accretion. Given the nature and significance of the loan portfolio to the overall performance of the bank, the administrative weaknesses associated with lending supported a 3-rated management component.

Earnings Rating

The earnings component was rated 4 in the ROE. The appeal stated that it should be rated 3. Earnings performance in the bank had been erratic. Excluding the results of the examination under appeal, the bank recorded a net loss in two of the last five years. In addition, loan losses exceeded net income in three of the last five years. After adjusting for the changes in classifications discussed above, losses would still exceed net income. The significant provisions to the ALLL have prevented earnings from adequately increasing the level of capital in the bank. The unsustained earnings performance, erratic fluctuations in net income and insufficient accretion of capital are characteristics of a 4-rated earnings component.

Composite Rating

A composite rating of 3 was assigned as a result of the examination. The appeal stated that the rating should be 2. At the time of the examination, the bank exhibited a significant degree of supervisory concern because of the lack of effective management and board supervision, which negatively affected the quality of the bank's loan portfolio and earnings stream. Given these weaknesses, the level of capital in the institution was strained, which lessens the ability of the bank to withstand business fluctuations that are common to banks in an agricultural-based economy. Therefore, a composite 3 rating appropriately reflected the condition of the bank.

Formal Agreement and Summary

Enforcement Actions are not appealable matters. As discussed in "OCC Bulletin 96–18: National Bank Appeals Process," when the primary supervisory office determines and notifies a national bank of its intention to pursue available remedies under applicable statues or published enforcement-related policies of the OCC, the decision becomes unappealable. Recognizing communication as an essential part of the supervisory process, the ombudsman encouraged the board to discuss the issues in the ROE with the supervisory office and specifically outline their course of action and the designated time frames for completing implementation of those actions. However, the bank was reminded that the final determination on enforcement action decisions rests with the supervisory office.

Appeal of Composite CAMELS Rating of 3 and Other Examination Conclusions

A bank formally appealed its composite rating, all component rating, bank information systems rating/year 2000 assessment (BIS/Y2K), and all risk assessment system (RAS) determinations. The assigned ratings were 4/344433 for the composite/CAMELS component ratings, respectively. BIS was rated 3 and Y2K was assigned a "Needs to Improve." RAS ratings were: strategic risk—high and increasing; reputation risk—high and increasing; credit risk—high and increasing; compliance risk—high and increasing; liquidity risk—moderate and increasing; transaction risk—moderate and increasing; interest rate risk—moderate and increasing. The board believed the ROE presented a very distorted picture of the bank in an effort to justify certain results intended to be achieved by the supervisory office.

Capital

Background

The appeal stated the bank was a well-capitalized institution under any benchmark of the OCC, FDIC, or the Board of Governors of the Federal Reserve and to say otherwise smacks of credulity. The appeal stated that the bank has increased capital every year for the past 50 years through its conservative nature, which is why the bank can weather the current credit problems. The ROE requests the bank adopt a capital plan. The appeal stated the bank had a capital plan in place for years and has always provided it to the examiners. The most recent plan was revised in August 1997.

Discussion and Conclusion

The ROE stated that capital is fair based on the high and increasing credit risk, poor earnings and ineffective control structures of the bank. Capital ratios at the time of the examination were above the requirements for the well-capitalized category; however, for the last two years, capital ratios had decreased. The rate of asset growth out-paced capital accretion. The supervisory office was concerned that capital adequacy was threatened by the bank's increasing risk profile.

During 1997, the board approved the formation of a holding company subsidiary to hold and sell the bank's other assets acquired from debts previously contracted. In order to capitalize the subsidiary, the bank issued a $3 million dividend to the holding company, which also contributed to the assigned capital rating.

The ombudsman determined that at the time of the examination, asset quality deterioration had affected capital. Extraordinary provisions to the ALLL eliminated earnings for the year and, therefore, earnings did not contribute to the accretion of capital. The majority of the actual capital decline in 1997 resulted from the decision to capitalize the holding company subsidiary to hold the bank's problem assets. While capital declined, this also removed, to some extent, some of the riskier assets from the bank's books. The level of identified risk and problem assets did not pose an immediate threat to the viability of the bank because of the capital base. The ombudsman's office further analyzed capital levels and determined the bank's capital base could absorb significant losses. Therefore, at the time of the examination, the ombudsman determined that a 2 rating more appropriately described the bank's capital position.

Asset Quality

Background

The appeal attributed the problems in asset quality to two officers that perpetrated fraudulent and unsound lending activities despite established underwriting guidelines. The appeal also pointed out that the circumvention of underwriting guidelines did not go unnoticed, but was uncovered by internal controls, specifically through delinquency reports. Loan review and audit reported exceptions to the executive officer responsible for lending who delayed responding to "cover his own tracks." The bank also noted that since the departure of the officer, asset quality trends had improved and loan review and audit had been strengthened and refocused. Lending policies had been revised and the ALLL calculation improved.

Discussion and Conclusion

The ROE stated asset quality is unsatisfactory based on continued declining trends, severe credit administration deficiencies, the lack of sound underwriting policies, and weak control mechanisms. Further the ROE asserted, the high level of risk and problem assets were significant and exposed the bank to continued credit losses. The supervisory office also noted the ALLL methodology was flawed, which resulted in questionable coverage for the inherent risks presented in the portfolio.

The ombudsman recognized that at the time of the examination, the increase in problem assets, the high level of past-due loans, and significant credit losses adversely affected asset quality and resulted in elevated credit risk. Board oversight and senior management supervision of lending activities and credit administration practices was poor. After examination charge-offs, 99 percent of classified assets were in the substandard category, indicating collateral provided some level of protection from losses. However, it was difficult to determine the true magnitude of the credit-oriented problems that confronted the bank. A significant level of underwriting exceptions occurred throughout 1997, and the majority of these credits were unseasoned. These credits possessed characteristics that mirrored the problem portfolios that had negatively affected the bank's financial performance. However, the level of identified risk and problem assets did not immediately threaten the viability of the bank because of the bank's capital position. The ombudsman determined that an asset quality rating of 3 was more reflective of the position that existed at the time of the examination.

Management

Background

The appeal stated that the board and senior management had successfully managed the bank for years, as supported by previous OCC comments, despite a local economy that had experienced difficulties. They made a mistake, by trusting an experienced executive officer. The appeal noted that the board recognized the limited depth of resources with the discharge of two loan officers, and had redirected personnel focus from corporate to bank matters. In addition the appeal asserted lending experience, however, remained considerable.

Discussion and Conclusion

The ROE stated management and board oversight was deficient, given the lack of management expertise and the limited depth of resources to address the significant risks threatening the safety and soundness of the bank.

The ombudsman determined, through discussion with bank representatives and the supervisory office, that management and the board did not exercise control over the bank's lending activities, which negatively affected earnings and capital at the time of the examination. The amount of resources dedicated to managing the level of risk and resolving the problems in the loan portfolio was inadequate. The loan portfolio represented the largest portion of the bank's balance sheet and the largest contributor to the income statement. Losses encountered in 1997 provide evidence the loan portfolio is significant to the bank's financial performance. Therefore, the ombudsman concluded a 4 rating was appropriate considering the deficiencies noted in overall board and management supervision of the bank's affairs.

Earnings

Background

The appeal noted earnings last year were more than adequate to support operations before increasing the ALLL to the level required by the OCC. Because all indirect loans had been credit scored, the board and senior management believed the greatest bulk of loss had been identified and appropriately reserved in the ALLL. The appeal recognized the bank's net interest margin had been declining and attributed it to competition and the rising costs of funds.

Discussion and Conclusion

The ROE stated earnings were unsatisfactory—insufficient to support operations, allow for appropriate capital accretion, and maintain adequate allowance levels. Future earnings streams were at-risk, given asset quality problems, the questionable adequacy of the ALLL, and strained net interest margin (NIM).

The ombudsman recognized that earnings were generated through traditional means with no extraordinary income sources. The bank relied almost entirely on the NIM coupled with low overhead and low ALLL provision expense to support its historically solid earnings. The NIM was relatively low and declining faster than for banks of similar size and characteristics over the last several years. Thus, it was important to control overhead costs and provision expenses to support net income levels. The bank's historical rate of return was not going to be recognized because of the material problems in the lending area. The capital growth would be significantly less than the bank had experienced in the past. The ombudsman determined the rapid declining NIM, the substantive drop in earnings experienced at fiscal year end, and the anticipated significant decrease in recurring earnings for the subsequent year provided support for the 4 rating assigned to the bank's earnings component.

Liquidity and Sensitivity to Market Risk

Background

The appeal stated the criticism of liquidity and sensitivity is lacking and further lends credence to the board's belief that the examiners needed to reach certain scoring criteria to arrive at predetermined composite rating. The bank had used a fairly detailed interest rate risk model for a number of years. To improve this risk assessment, the bank began working with a nationally recognized model, using standard assumptions until bank staff is more familiar with the model. The interest rate risk program has been complemented by the OCC in the past. In addition, the appeal noted the bank's liquidity was very strong at the date of the ROE and even stronger as of the submission of the appeal. The ROE was critical of the bank's liquidity largely on what might happen in the future. The bank's liquidity policy had never been criticized in past OCC examinations.

Discussion and Conclusion

The ROE assessed liquidity and sensitivity to market risk as "Fair." The supervisory office noted that while funds management policies and processes had been established, management remained in the development stage with monitoring and reporting mechanisms. Further, the current financial stress on the bank, the uncertainty of 1998 earnings performance, and management's response to such trends expose the bank to increasing liquidity and interest rate risk. The bank also lacked a formal liquidity contingency plan.

The ombudsman review determined the bank had a stable core deposit base and an adequate liquidity position. The amount of liquidity and the bank's policies and practices were sufficient to ensure adequate liquidity to meet funding needs. Almost 9 percent of total assets were in federal funds sold, with an additional 11 percent in unpledged investment securities. Supervision was adequate regarding liquidity and funds management practices. Based on these facts the Ombudsman determined a 2 rating was more appropriate for the bank's liquidity position.

The level of interest rate risk (IRR) at the time of the examination was low and well within policy limits. In addition, the bank measured equity at risk, which also was within the bank's policy limit. Adequate risk management processes were in place to monitor sensitivity to market risk. The ombudsman concluded a 2 rating was appropriate at the time of the examination.

Bank Information Systems Rating/Year-2000 Assessment

Background

The appeal stated the board and senior management addressed the data processing needs, as well as Year-2000 (Y2K) compliance prior to the examination, and were clearly focused on the problem. They were committed to staying on schedule. Initial input received from OCC examiners was that the new system was a good choice and they were pleased with Y2K progress.

The appeal noted that OCC rated liquidity "Fair" because of events that might occur in the future, and yet rated BIS "Less than Satisfactory" with no regard or credit given for the near future event of a complete management information systems (MIS) changeover. The bank stated this jaundiced grading lacks credibility and should be wholly discounted in the appeal.

Discussion and Conclusion

The reasons provided in the ROE for the *Less than Satisfactory* rating for BIS and Y2K compliance were:

- Deficient board and management rating;
- Distressed financial condition of the bank; and
- Management's commitment to address significant asset quality issues.

While it was true that asset quality deterioration had significantly affected the bank's earnings and overall condition, there was no evidence to suggest this would materially affect BIS activities and Y2K compliance and remediation efforts. At the time of the examination, the bank's efforts were in compliance with the established time line for the system conversion. During the processing of the appeal it was determined that bank management remained on schedule. Based on the information reviewed, the bank's Y2K compliance efforts were satisfactory and the information systems department met the *FFIEC Information Systems Handbook* (1996) definition of a 2-rated department.

Risk Assessment System

A risk assessment system (RAS) comparison is presented on the following chart, followed by a detailed discussion of the factors contributing to the ombudsman's decision.

Risks	Supervisory Office	Ombudsman's Office
Strategic	High/increasing	High/increasing
Reputation	High/increasing	High/increasing
Credit	High/increasing	High/increasing
Interest Rate	Moderate/increasing	Moderate/Stable
Liquidity	Moderate/increasing	Low/increasing
Transaction	Moderate/increasing	Moderate/increasing
Compliance	Moderate/increasing	Moderate/Stable

Strategic Risk

The board's strategic implementation of the conversion to a new computer system and Y2K had been very thorough and continued to proceed with little or no glitches. During the ombudsman's visit with the board, they discussed the bank's extensive experience in out-of-territory lending, with minimum losses. However very different from its history, the bank encountered rapid growth originated by relatively new officers that assured the board appropriate steps were being taken to address potential problems and protect the bank. A high-risk assessment considers the impact that problems in indirect lending and the shortage of resources in the bank to resolve these issues had on the franchise value in 1997. The need to re-engineer the lending area, the level of unidentified risk in the indirect lending portfolio, and the negative impact indirect lending was expected to have on 1998 earnings caused strategic risk to be increasing.

Reputation Risk

The bank's vulnerability to negative market perception in light of the large losses in 1997, the volume of repossessed marine craft, and the number of accounts affected by fraudulent activities support a high-risk assessment. The determination that reputation risk was increasing captured the uncertainty of not knowing how the community would respond to issues associated with the board's inadequate control over indirect lending and competitors' ability to use these problems in their marketing efforts.

Credit Risk

Credit-related losses had necessitated abnormally high ALLL provisions to cover inherent losses. Exposure to earnings from credit risk was substantial, evidenced by the losses in 1997 and the budgeted ALLL provisions for 1998. At the time of the examination, the department lacked the necessary resources to work through problems within a reasonable time frame. In addition, the nature of the repossessed collateral could extend the time needed to resolve the credit problems. Based on these factors credit risk was high and increasing.

Interest Rate Risk

The bank had a low level of earnings exposure to IRR, moderate exposure in terms of equity at risk, and satisfactory IRR measurement and monitoring. Because of the interrelationship between IRR, liquidity, and funds management practices, and because of the bank's higher volume of longer-term fixed-rate assets, moderate risk was appropriate. With improved modeling and reporting capabilities, management should be able to better monitor and control the bank's IRR exposure.

Liquidity Risk

The bank had a high level of balance sheet liquidity, a solid core deposit base, sufficient off-balance-sheet sources, and adequate measuring systems in place, indicating low liquidity risk. However, there was the potential of a negative impact on liquidity at the time of the examination based on reputation risk. The issues facing the bank and the inevitable publicity that follows in a small community, caused liquidity risk to be increasing.

Transaction Risk

The bank was planning a major system conversion for the third quarter of 1998. A major conversion can and usually does increase a bank's transaction risk profile. The bank had to migrate and reconcile two sources (mainframe and PC-based) to the new system. In addition, the bank's time frame was aggressive. Therefore, transaction risk was increasing.

Compliance Risk

Management uses automated tools to assist them in minimizing compliance exposure. Compliance management systems had been adequate to avoid significant or frequent violations. The moderate assessment represents an increase in compliance risk since the December 1996 compliance examination. Although at the examination, several violations of Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (Regulation O) were identified, the bank had no history of violating this regulation. The limited compliance scope of the examination did not support a change from the stable assessment.

Composite Rating and Summary

At the time of the examination the bank exhibited a significant degree of supervisory concern because of the lack of effective management and board supervision, which negatively affected the quality of the bank's loan portfolio and earnings stream. The level of capital support at the time mitigated a more severe composite rating. Therefore, the ombudsman determined that a 3 composite rating was more reflective of the condition of the bank at that time.

However, the ombudsman was concerned with the adverse trends that had continued to develop during the processing of the appeal. The condition of the bank deteriorated further and provided sufficient evidence to justify a higher level of supervisory concern. Asset quality problems continued to deplete earnings and trends had not reversed. A full year had expired since the problems first surfaced and the depth of the asset quality problems were still not quantified. The level of non-performing assets was exceptionally high and there had been no comprehensive, independent evaluation of the loan portfolio to identify the full magnitude of the problem. The condition of the bank was more characteristic of a 4 composite rating, primarily because of management and the board's lack of effective steps to control the continued deterioration in asset quality and impact on the bank's earnings stream and capital base. Therefore, the ombudsman did not change the bank's overall composite rating, nor its capital or asset quality component ratings, in the OCC's official supervisory record.

Appeal of 3 Composite CAMELS Rating of 3 and Various Component Ratings

Background

A bank formally appealed several conclusions in the ROE, which included:

- The composite CAMELS rating;
- The capital, asset quality, management, and earnings component ratings;
- The request for a provision to the ALLL;
- The assessment of the bank's risk profile; and
- The evaluation of the bank's internal audit function.

In addition, the appeal submission expressed a serious concern that the supervisory office had engaged in a pattern of "vindictive treatment."

Asset Quality (3-rated)

Discussion and Conclusion

The bank's appellate submission stated:

The ROE completely abandoned objective factors for the subjective considerations in the area of asset quality. The ROE attempts to justify a 3 rating by subjective evaluations of the bank's credit risk and credit risk evaluations, while completely ignoring the actual levels of non-performing assets and minimal level of charge-offs. An assignment of a 3 rating in this area was unwarranted because underwriting criticisms were disproportionately based on OCC's identified "structurally weak" loans.

The ROE concluded that asset quality was less than satisfactory and that credit risk management practices were unsatisfactory. The ROE stated the basis for those conclusions were a deficient loan policy, pervasively weak underwriting practices, an unacceptable level of non-performing assets, aggressive loan growth, a rising level of classified and criticized assets, and the absence of risk limits for the numerous concentrations of credit.

The ombudsman conducted two meetings with bank management during the processing of this appeal. One meeting included members of the ombudsman's office and senior management in the bank. The other meeting included senior management of the bank, members of OCC's supervisory office, a member from the OCC's Credit Policy Division in Washington, D.C., and a member of the ombudsman's staff. The meetings were important to provide a better understanding of the organizational and credit cultures within this institution, and to ensure that OCC supervisory policies were being implemented as intended. The second meeting, facilitated by the ombudsman's office, provided an opportunity to gain a practical understanding of the bank's credit culture. The loan-by-loan review of the borrowers listed in the "Loans with Structural Weaknesses" section presented additional information and insight that would have led to the exclusion of many of these loans from that section of the ROE. Although the supervisory office personnel held discussions with senior management, in most cases, it was clear that they did not have full knowledge of the particular circumstances of the borrowers when preparing this section of the report.

Officers were able to discuss the mechanics of commercial real estate (CRE) lending and demonstrated an awareness of the related risks. The officers were successful in explaining why most of the loans on those pages were appropriately underwritten. OCC's supervisory office personnel acknowledged the ROE comments would have been more balanced had these types of discussions occurred during the examination. Members of the supervisory office agreed that the concern with underwriting, based on the discussions, resulted primarily from lack of documentation. The ombudsman reminded bank management of the importance of documented analysis becoming a part of the lending process to ensure that risks have been appropriately identified and addressed on a consistent basis.

While the discussion with management demonstrated an understanding of the risks involved with CRE transactions, the concerns expressed within the ROE, which focused on sound processes and procedures to manage the loan portfolio, were not eliminated. These were not new regulatory expectations or banking concepts. Effective loan portfolio management and recommendations detailed in the ROE included:

- A comprehensive awareness of the regulation governing appraisals, including the establishment of a formal process to review appraisals. This is especially important for banks specializing in CRE lending.
- An internal loan review function that accurately identifies and categorizes the risks associated with credit relationships. Additionally, the function must assess compliance with the board's established loan policy, compliance with regulatory guidelines, the adequacy of the ALLL, and the overall quality of the loan portfolio.
- The establishment of prudent limits on concentrations of credit in terms of capital, given the potential impact large exposures to any industry/segment can have on the bank's capital base, should problems occur in that area.
- A comprehensive understanding of the demands and other obligations of the individuals the bank is looking at to support the credit. While the borrowers' character is a vital component to consider when lending, experience has shown that during periods when the economic landscape is more difficult, a borrower's willingness to repay debt is significantly affected by the volume of contingent liabilities and unencumbered assets.

In the appellate submission and during meetings at the bank, management emphasized the initiatives taken since the examination. Many of which (independent loan review, internal appraisal review process, independent appraisal review, documentation of property inspections, and policy for construction site visits) related to identified concerns in the ROE. Credit risk management concerns had consistently been the focus of the last three examinations. While progress had been made, risk management activities had not kept pace with the bank's growth. As evidenced by management initiatives during the processing of the appeal, risk management weaknesses identified in the ROE did exist. Although the quantitative asset quality measures within the institution were not alarming, OCC Bulletin 97–1, "Uniform Financial Institution Rating System" (January 3, 1997) describes in its attachment *(Federal Register,* December 19, 1996, vol. 61, no. 245) a 3 rating as less than satisfactory asset quality *or* credit administration practices. In considering the issues described above, the ombudsman concluded that the 3 rating, assigned at the time of the examination, was appropriate based on the bank's deficient credit administration practices.

ALLL

Discussion and Conclusion

The appeal stated an additional provision to the ALLL is not warranted based on the level of past due and non-performing loans, and the bank's history of minimal loan losses. The appeal further noted that:

The ROE completely disregarded the bank's historical record on the incorrect basis that the lending practices and loan portfolio of the bank had changed in recent periods. And on the basis of primarily subjective analyses of the bank's risk profile and lending management, the ROE requested an additional provision. And the bank was hard pressed to justify such a drastic addition to the bank's ALLL under GAAP [generally accepted accounting principles].

The ROE comments highlighted that management's analysis was questionable because it did not incorporate reasonable, logical adjustments to historical loss experience for qualitative factors. The ROE stated, "For example, loan growth has remained high, the composition of the loan portfolio has changed, and credit risk management practices are deficient. Yet, management adjustment for these factors and other qualitative factors remained nominal."

The OCC's position on making provisions to the ALLL states the ALLL must be maintained at a level that is adequate to absorb all estimated inherent losses in the loan portfolio. One of the objectives of the examination is to evaluate the soundness of management's allowance determination process. While the bank's historical loss experience was a reasonable starting point for the analysis, adjustments for various qualitative factors to reflect current conditions are also prudent. As defined in the *Comptroller's Handbook* booklet, "Allowance for Loan and Lease Losses" (June 1996), these factors include:

- Changes in lending policies and procedures, including underwriting standards and collection, charge off, and recovery practices.
- Changes in national and local economic and business conditions and developments [or add], including the condition of the various market segments.
- Changes in the nature and volume of the portfolio.
- Changes in the experience, ability, and depth of lending management and staff.
- Changes in the trend of the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, troubled debt restructurings, and other loan modifications.

- Changes in the quality of the institution's loan review system and the degree of oversight by the institution's board of directors.
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations.
- The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio. [p. 40]

The examination found that management's analysis did not provide prudent adjustments for qualitative factors. The analysis the supervisory office provided to bank management included adjustments to the historical loss percentage for the various qualitative factors. However, in several of the qualitative areas, the supervisory office included duplicate adjustments for underwriting weaknesses. Additionally, the supervisory office analysis inappropriately included adjustments for types of loans when the historical loss percentage was adequate.

The ombudsman concluded that correcting these adjustments reflected a need for a provision of a lesser amount. The bank was directed to refile the bank's Call Report to reflect these changes.

Capital Adequacy (3-rated)

Discussion and Conclusion

The bank's submission noted that "In view of the bank's maintenance of strong capital levels, significantly in excess of all 'well-capitalized' benchmarks during all recent periods, the assignment of a 3 capital rating is unwarranted as well as unsupported by the ROE. The ROE bases the downgrade of the bank's capital rating solely on highly debatable and completely subjective assertions regarding the high risk."

The ROE stated that their assessment of capital was based on the high-risk profile of the bank and the generally inadequate risk management systems. The ROE further stated that the burden of providing a reasonable return on equity has ultimately led to subsequent increases in risk, which had not been preceded, or even accompanied, by commensurate improvements in risk management.

While the "well capitalized" definitions refer specifically to prompt corrective action, the OCC is authorized under 12 USC 3907 (a)(2) to establish higher minimum capital requirements, in light of the particular circumstances at a bank. Adequate capital levels should be maintained commensurate with the risk profile of the institution and management's ability to implement effective risk management systems.

The ombudsman determined that while there were risk management weaknesses in different areas of the bank, the primary risk in this institution was credit risk. As such, the risk to capital, posed by the banks lending activities, should also consider the risk of loss in the event of default. Comments in the ROE acknowledged that excessive credit losses were mitigated by the documented value of real estate collateral. Additionally, comments in the ROE acknowledged management's prior success in raising capital when warranted. The ombudsman concluded that when these factors are properly weighed, the bank's capital position was more appropriately represented by the 2 rating.

Earnings (2-rated)

Discussion and Conclusion

The appeal stated that "An assignment of a 2 rating was unwarranted, as the bank had recorded strong earnings and increased earnings in each of the last five years. In the face of the bank's consistent earnings results and historically low charge-offs, the ROE asserts that a combination of higher ALLL provisions mandated by the OCC, *less than satisfactory* asset quality, and purportedly high credit risk may impact the sustainability of earnings performance."

The ROE stated that earnings performance was satisfactory due, primarily, to high loan yields and fees and well-below-average operating cost. It also stated that while the quantity and trend of earnings appear satisfactory to strong, earnings were actually lower than reported and there were several factors that may affect the sustainability of earnings. Earnings were negatively affected by a reversal of a significant discount that was recognized as income in conjunction with the modification of a then problem loan and the need to increase the ALLL to an adequate level. The ROE also discussed issues involving the sustainability of earnings, which included credit risk concerns, and a significant repricing imbalance caused by funding commercial loans, which reprice in three to five years, with wholesale funding, which reprices over the next 12 months.

The earnings component is designed to reflect the quantity, trend, and quality of earnings generated by the institution. Management had been successful in generating a significant level of fee income and purchasing loans at a discount to elevate earnings performance. The level of earnings for the period was negatively affected by the reversal of income on the previously noted problem loan and a required provision to the ALLL. Additionally, there were risk management issues that will require financial resources to properly develop and implement. In considering all of these factors, earnings were sufficient to support operations and maintain adequate capital and allowance levels, even after considering the risk management issues that need to be addressed.

The ombudsman concluded that the assigned 2 rating for the earnings component was appropriate at the time of the examination.

Internal Audit

Discussion and Conclusion

The appeal stated, "Many of the ROE conclusions about the bank's risk management are based on flawed findings about the internal audit function. The ROE incorrectly concludes management had dismantled the internal audit function, when in fact the bank had continued the engagement of a highly respected audit firm to conduct the internal audit for the third consecutive year."

The ROE stated that the internal audit function—temporarily improved in response to a "Matter Requiring Board Attention" comment contained in the previous ROE—was again unacceptable, having been dismantled prior to completion of even one 18-month cycle. Additionally, it noted the external audit lacked the scope required to adequately compensate for the absence of an internal audit function in such a high-risk bank.

The ombudsman's review found that the supervisory office's supporting work papers on the bank's internal audit function did not fully support the conclusion that the internal audit had been dismantled, as stated in the ROE. However, a review of the audit schedule, the completed audits, and discussion with the firm contracted to perform the internal audit function revealed that some audits were not performed in a timely fashion. The ombudsman concluded that at the time of the examination these symptoms were more indicative of a "partially acceptable" internal audit function.

Management (3-rated)

Discussion and Conclusion

The appeal stated that an assignment of a 3 rating was unwarranted because of the bank's successful financial performance. The appeal also noted that the management team had continually improved processes and procedures but was most capable because of its "hands on" process. Management asserted that knowing the customer at the ownership level and personally having a senior officer visit every business site represented the most valuable component of their lending process.

The ROE stated, "Management is less than satisfactory, as the overall risk profile remains high and risk management remains deficient. Management remains overly focused on the upside potential of business strategies at the expense of prudent considerations and control of the downside risk." The ROE further stated, "Management and the board have failed to ensure the bank has a long-term well-defined business plan. And while management had made changes in response to previous supervisory concerns, the changes lack durability and integrity to alleviate the concerns."

The management rating reflects the board and management's ability as it relates to all aspects of banking operations. The bank's senior management team had been successful in growing the bank, raising capital to support growth, and exiting product lines that were deemed unprofitable. However, at the time of the examination, concerns included credit risk activities that did not provide comprehensive oversight of the loan portfolio, an internal audit function that was only partially acceptable, compliance management weaknesses, interest rate risk monitoring systems that needed improvement, and liquidity management activities that required enhancements.

Many of these risk management concerns were highlighted in the previous ROE. The board and management had initiated actions to strengthen risk management systems after the conclusion of the examination. However, senior management had not demonstrated a willingness to maintain risk management systems commensurate with the growth and activities of the bank. Therefore, the ombudsman concluded that at the time of the examination a "3" rating for management component was appropriate and justified.

Composite Rating (3-rated) and Assessment of the Bank's Risk Profile

Discussion and Conclusion

The ROE stated the condition of the bank had deteriorated and is less than satisfactory. Comments in the ROE noted the deterioration resulted from elevated risk levels combined with risk management systems that remain ineffective in relation to the level of risk.

The appeal stated that "An assignment of a 3 composite rating and "high and increasing" risk profile is unwarranted based on objective facts and measurements. The common thread used by the supervisory office throughout the ROE to justify downgrading the bank component and overall rating was that the risk profile of the bank is high and increasing." While acknowledging the risks inherent in their mix of lending, management stated in the appeal that the primary test should be their experience in controlling losses, which they point out had been exemplary.

Given the general risk management weaknesses in the bank, which have been described throughout this summary, the risk profile of the bank would be appropriately categorized as high and increasing, particularly given the concerns in asset quality, liquidity, and sensitivity to market risk. The overriding regulatory concern in the bank was management's unwillingness to establish and, more importantly, maintain risk management systems appropriate for the activities of the bank. In considering the composite rating definitions contained in OCC Bulletin 97–1, financial institutions that exhibit some degree of supervisory concern in one or more of the components; and, management that lacks willingness to effectively address the weaknesses in appropriate time frames generally receive a 3 rating. Therefore, the ombudsman concluded that the 3 rating was appropriate, at the time of the examination.

Pattern of Vindictive Treatment

The ombudsman views a charge of a pattern of vindictive treatment as a serious matter that always warrants careful and comprehensive review and investigation. The ombudsman reviewed the previous ROEs and there was a common thread in that each report had essentially dealt with criticisms by the supervisory office on identified weaknesses in risk management activities. Management initiated corrective action following each ROE and the supervisory office had accepted their response as an indication of their intent to address the issues. The supervisory office had altered planned courses of action, and when warranted, upgraded composite and component ratings in subsequent examinations. However, corrective action was not always fully implemented or did not comprehensively address the concerns. Despite some comments in the current ROE that lacked balance and had an aggressive tone, there was no evidence that this represented retaliation. The ombudsman concluded that the lack of balance and aggressive tone resulted from poor communications during the examination process by both regulators and bankers coupled with the unwillingness of management to sustain progress in developing and implementing effective risk management systems.

During the processing of the appeal, which included the visits to the bank, the ombudsman had gained a healthy respect for management's business model and core abilities. However, based on the lack of follow-through on prior commitments, he expressed disappointment that management had not fully implemented a platform of effective and comprehensive risk management systems, processes, and controls. He further reminded management and the board that risk management activities were an important component of operating any financial institution in a safe and sound manner and were within management's control to develop and implement.

In addition, the ombudsman discovered that the supervisory office had not completely fulfilled its obligation to adequately communicate findings to the board and management during the examination. Thus the ombudsman also shared with the supervisory office his view that the examination should have been conducted in a manner that promoted greater communication with senior management and the board of directors.

Appeal of 3 Composite Rating

Background

The ombudsman received a formal appeal from a bank that disagreed with their assigned 3 composite rating. The composite rating was assigned as a result of a full scope onsite safety and soundness examination. As a result of the examination, the bank entered into a Part 30 Safety and Soundness Compliance Plan. Subsequent to the full-scope onsite examination, the supervisory office conducted a review of the bank to assess compliance with the plan. At that time the bank was not in full compliance with the plan and their composite rating remained unchanged.

The bank's correspondence outlined the following as the basis for the appeal:

- The bank has made significant progress in correcting and complying with the areas of regulatory concern as outlined in the report of examination and the plan.
- The bank is well capitalized with good asset quality, and has experienced management team with a long track record of performance.
- The bank has excellent earnings and sound liquidity.

The risk associated with the acquisition of a high level of a particular type of loan product from another financial institution was unprecedented in the history of the bank. The OCC's supervisory office had already provided the bank with appropriate feedback on areas where more selective due diligence was warranted as well as areas where more effective risk management practices for these assets should be implemented. The most important dimension of this situation was the aggressive approach taken by management to work through the various risk related challenges associated with this pool of assets. Although management had not anticipated or prepared for assuming the multifaceted risks associated with booking these assets on the balance sheet, the supervisory office commended the bank for the strong efforts to improve the risk management infrastructure. Additionally, a comprehensive action plan was developed to strengthen and improve the credit risk management processes. This action plan was the primary basis from which the supervisory office developed the plan. Bank management had taken notable action for achieving compliance with the Plan in a relatively short period of time, but had not achieved full compliance. The articles not in full compliance were considered critical components of the overall risk management processes.

Discussion

In the attachment to OCC Bulletin 97–1, "Uniform Financial Institutions Rating System," the *Federal Register* notice (December 19, 1996, vol. 61, no. 245) states:

> Composite 2—Financial institutions in this group [rated 2] are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.
>
> Composite 3—Financial institutions in this group [rated 3] exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions. (p. 67026)

Conclusion

The quality of management is a key element in the operation of a national bank and is usually the factor that is most indicative of how well risk is identified, measured, monitored, and controlled. The bank's actions to strengthen its risk management infrastructure and control the risk associated with the acquired loans were reflective of a management team that is able to respond to changing, and in this case unprecedented, circumstances and business conditions. Such an infrastructure, coupled with prudent banking practices, serves as the foundation that supports sound financial institutions during periods of market or economic stress, and was more appropriate given the bank's size, complexity, and risk profile.

While many of the bank's actions had been reviewed during the subsequent review, not all systems were in place at that time, and the effectiveness of the overall risk management process had not been fully tested during an onsite examination. Since an onsite examination was scheduled to commence within 30 days of the appeal, the ombudsman opted to have the risk management infrastructure fully tested during that examination. Therefore, the composite rating of 3 was upheld by the ombudsman.

Subsequent Event

The supervisory office assigned an overall 2 composite rating to the bank at the next examination.

Appeal of Sensitivity to Market Risk, Earnings, and Management Component Ratings

The ombudsman received a formal appeal of examination conclusions involving the sensitivity to market risk, earnings, and management component ratings. The bank's appeal stated that in the ROE the OCC assigned the bank a 3 rating for sensitivity to market risk, a 5 rating for earnings, and a 5 for management. Bank management and the board of directors' contention was that these CAMELS component ratings did not accurately reflect the bank's condition at the time of the examination.

Sensitivity to Market Risk—ROE Rating 3

Background

Management and the bank's board believed that neither the condition of the bank's sensitivity to market risk as of the examination date, as compared to the last examination, nor the quality of the bank's Asset/Liability Management Policy warranted the OCC downgrading the bank's Sensitivity to Market Risk rating from a "2" to a "3." Furthermore, by commissioning reports with outside consulting firms, which also reflects the positive state of the bank's interest rate risk management, the bank has illustrated sound risk management policies and procedures.

The supervisory office concluded in the ROE that the bank's interest rate risk was slightly elevated because of an imbalance resulting from assets repricing faster than liabilities. The ROE also commented that the board and management planning and risk management processes were deficient. Additionally, the supervisory office believed the Asset/Liability Management Committee had not taken an active role in managing the balance sheet or interest rate risk.

Discussion and Conclusion

In accordance with OCC Bulletin 97–1 ("Uniform Financial Institutions Rating System") the sensitivity to market risk rating is intended to reflect the degree to which changes in interest rates can adversely affect the earnings and capital of a financial institution. Considerations in determining the sensitivity rating are management's ability to identify, measure, monitor, and control market risk, and the adequacy of the capital and earnings in relation to the bank's level of interest rate risk exposure.

The ombudsman's review did not find adequate support that the board and management was actively managing the bank's IRR position. Review of the information provided to the ombudsman's office revealed:

- The input and assumptions used in the modeling were not well supported and hindered an accurate assessment of the risk, making it difficult to quantify the bank's risk exposure.
- While the bank had purchased a complete bank simulator model, allowing for greater accuracy and more assumptions, the bank had never used this model.
- The modeling reports reflected gap positions outside of those limits established in the Asset/Liability management policy of the bank.

- The Asset/Liability Committee (ALCO) minutes provided no insight on management's and the board's efforts to manage IRR. The only discussion reflected in the ALCO minutes was pricing of depository products, which lacked detail. Furthermore, the minutes did not reflect the board's desired balance sheet composition or strategy to manage IRR.

Based on the risk management weaknesses described above, the ombudsman concluded that the 3 rating assigned during the examination was appropriate.

Earnings—ROE Rating 5

Background

The bank's submission commented that:

Although at the time of the last ROE, the bank was experiencing losses, it was taking steps to increase earnings. During the past year, the bank commenced its SBA and Credit Card program, both of which introduced a significant revenue stream to the bank. The bank's earnings trend is not negative and does not represent a distinct threat to the bank's capital. During this time the bank also raised additional capital to compensate for funding the increased provision for loan losses. The increase in revenue from the last examination and the nature of the bank's expenses in no way can justify the downgrading of the bank's earnings rating. The OCC's assignment was wholly improper.

Comments in the ROE concluded that earnings remain poor and were eroding the bank's capital. The supervisory office also stated that management and the board needed to take immediate and ongoing action to alleviate large continuing losses and address the other weaknesses. Examiners' primary concern was that continuing losses of the magnitude experienced in the last years would threaten the bank's viability.

Discussion and Conclusion

Pursuant to OCC Bulletin 97–1 ("Uniform Financial Institutions Rating System") earnings are intended to reflect not only the quality and trend, but also factors that may affect the sustainability or quality of earnings.

Considerations in determining the earnings rating are the following:

- The level of earnings, including trends and stability,
- The ability to provide for adequate capital through retained earnings,
- The quality and sources of earnings,
- The level of expenses in relation to operations,
- The adequacy of provisions to maintain the allowance for loan and lease losses, and
- The adequacy of the budgeting systems and forecasting processes.

The ombudsman review revealed that over the last two years, the bank had no traditional core earnings. The bank experienced net-operating losses in the last two years of approximately $600 thousand and $900 thousand, respectively. These losses included provisions to the allowance for loan and lease losses of $600 thousand and $700 thousand, respectively. Furthermore, the net interest margin declined from 4.60 percent to 3.80 percent in the same time period due to increasing funding costs and declining loan yields. Net losses had eroded capital, necessitating an injection of capital.

Additionally, the earnings posture of the bank could be further affected by the bank's risk profile and risk management practices. These include:

- The bank's high credit risk profile as evidenced by the level of classified assets centered in the unguaranteed portion of SBA loans, past dues, and non-accruals.
- Measuring and monitoring risk management systems. For instance, credit risk identification, underwriting standards, loan grading, allowance methodology, and collection efforts remain deficient.
- A weak budgeting process with overly optimistic assumptions based on past performance.

The bank's earnings posture, the high risk profile of the bank, and the questionable future prospects cause a significant supervisory concern and represent a distinct threat to the bank's viability through the erosion of capital. Therefore, the ombudsman concluded that the 5 rating assigned during the examination was appropriate.

Management—ROE Rating 5

Background

The bank's appeal letter stated management and the board have made a concerted and significant effort to improve the depth and stability of bank management by making position-specific improvements. They believed that through the creation of new officer positions and the hiring of new officers, the bank management team was significantly stronger at the time of this examination than at the time of the last examination. For these reasons, bank management believed a downgrade in the bank's management rating was inconsistent with the actual condition of the bank.

The ROE stated management and the board's supervision was ineffective. The ROE comments also asserted management actions were not substantive nor were they taken in a timely manner to strengthen the bank's loans and risk management systems. The bank continued to experience turnover in management and the board. Additional examination findings revealed the bank did not have a legal number of directors, the president/chief-lending officer was terminated, and the chief financial officer resigned.

Discussion and Conclusion

Pursuant to OCC Bulletin 97–1 ("Uniform Financial Institutions Rating System") the management rating is intended to reflect the capability and performance of the board and management. Some considerations in determining the management rating are:

- The level and quality of oversight and support of all activities in the bank,
- The overall performance of the bank and its risk profile,
- Management depth and succession,
- The adequacy and reliability of financial and regulatory reporting,

- The accuracy, timeliness, and effectiveness of management information and the risk monitoring systems appropriate for the institution's size, complexity, and risk profile,
- The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risk of significant activities, and
- The ability of the board of directors and management in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products.

The ombudsman's review revealed that the position-specific appointments did not improve the depth, stability, and expertise needed in the board and management. This finding was based on the following:

- The board and management did not demonstrate the ability to reverse the deteriorating trends and improve the poor financial condition of the bank.
- The board and senior management had not developed and maintained appropriate risk management systems given the risk profile of the bank.
- Both the board and management were unstable with no strategic direction given the continual turnover in executive management.
- The bank had operated without the legal number of directors for the last two years.

Strong leadership is essential in a financially troubled institution. The board's effort to provide leadership had not been effective. Therefore, the ombudsman concluded the 5 rating assigned during the examination was appropriate.

Appeal of Composite and CAMELSI Component Ratings

Background

A bank operating under a formal agreement appealed the composite rating and each of the CAMELSI [capital, asset quality, management, earnings, liquidity, sensitivity to market risk, and information technology) component ratings, 3/3343233, respectively. Additionally, the bank expressed a desire to appeal many of the conclusions in the report of examination (report) that supported the ratings.

The directors and management also expressed concern with the lack of objectivity in the report and an alleged bias by the supervisory office in their assessment of the bank's condition. Additionally, there was a concern over the difficult communications between the supervisory office and bank management. Management and the board were explicit in stressing that they endeavored to work through their disagreements with the supervisory office over a number of years. Their decision to file an appeal after the most recent examination was made after concluding that third party intervention by the ombudsman was the only way to restore balance to the supervisory process. Finally, the appeal requested the ombudsman facilitate a change in supervisory office.

Discussion

The OCC Bulletin 2002–9, "National Bank Appeals Process: Guidance for Bankers," February 25, 2002, (bulletin), makes clear that banks cannot seek ombudsman review of agency decisions for which banks are provided with an appeal mechanism by statute or OCC regulation, or where the decision is subject to judicial review. These include agency decisions to pursue formal enforcement action or recommended decisions following formal or informal adjudications pursuant to the Administrative Procedures Act, 5 USC 701 et seq., agency actions that are subject to judicial review, and decisions made to disapprove directors and senior executive officers pursuant to Section 914 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, 12 USC 1831i.

While the bulletin does not allow appeals of the underlying facts of an enforcement action, it does permit material supervisory determinations to be appealed even when an enforcement action has been taken. In such circumstances, the OCC's ombudsman, without engaging in additional fact-finding, applies relevant OCC policies and standards to the existing facts to determine whether the agency's conclusions are consistent with those policies and standards.

The bank's correspondence explained that their appeal was not requesting the ombudsman's involvement with supervisory decisions pertaining to compliance with the existing formal enforcement action or any subsequent decisions to pursue additional enforcement actions.

The ombudsman conducted a comprehensive review of the information submitted by the bank and documentation from the supervisory office. The review included meetings with members of the bank's board of directors, senior management team, and legal counsel. The ombudsman also met with members of the supervisory office. The ombudsman review focused on whether there was adequate support for the assigned ratings and whether the ratings reflected the condition of the bank at the time of the examination.

Conclusion

The ombudsman determined that the assigned composite and CAMELSI component ratings were appropriate at the time of the examination. The report of examination also appropriately addressed the need to strengthen the bank's risk management systems. However, the ombudsman identified several instances where the report lacked proper balance. The wording and tone of the report was too harsh and did not give recognition for the bank's positive actions. Further, the report did not consider the unique aspects of the bank's operating environment. Given the length of time since the onsite examination, the ombudsman decided a new examination was needed as opposed to rewriting the report.

The ombudsman held discussions with the district deputy comptroller to encourage measures that would ensure appropriate balance during the next examination, recognizing the unique aspects of the bank's operating environment. Bank management was encouraged to aggressively direct their attention and efforts toward institutionalizing a culture that is reflective of strong risk management systems and internal control processes throughout the bank. Such an effort would yield huge dividends internally as well as eliminating the basis of most of the prior OCC criticisms and recommendations.

Appeal of a Violation of the Legal Lending Limit

Background

The ombudsman received a second tier formal appeal of a violation of 12 USC 84, the Legal Lending Limit. The supervisory office combined the loans to six individual borrowers under 12 CFR 32.5 (b) “Direct Benefit” and 12 CFR 32.5 (c) “Common Enterprise” rules. After the violation was cited in the ROE, the bank initially appealed the violation to the Office of the Chief Counsel in Washington, D.C. The Office of the Chief Counsel opined that a violation of the legal lending limit had occurred; bank management then opted to appeal the cited violation to the ombudsman.

The legal lending limit violation cited in the ROE resulted from the combining of unsecured loans to six individual borrowers. The loan proceeds were invested in a real estate development limited liability company. Collectively, these six individuals own 100 percent of the company. The appeal letter stated the bank was not relying on the real estate development entity for repayment of the debt, hence there was no performance risk associated with the company. Bank management stated the loans were made to the individuals based on each individual’s credit worthiness and capacity to repay the loan.

The appeal letter outlined the following as the basis for the bank’s appeal:

- Only two of the individuals have “voting rights or voting interest,” except in certain limited situations, and the limited liability company structure does not require a person to have voting rights in equivalent proportion to their investment. To the extent that the prior decisions relied upon by the Office of the Chief Counsel were based on corporate structures or more traditional partnership structures where dollars of investment equaled voting power, a different analysis should be applied here and a different conclusion reached.
- Given the fact that each loan was underwritten based on the individual borrowers’ creditworthiness, coupled with the limited exposure of each borrower under the limited liability company structure, the credit diversification goal of 12 USC 84 is met.
- Under the facts of this situation there is no risk related to undo industry concentration, nor are the technical requirements of “common enterprise” met.

Discussion

Generally, a national bank’s total outstanding loans to one borrower may not exceed 15 percent of the bank’s capital and surplus, plus an additional 10 percent of capital and surplus if the amount over the 15 percent general limit is fully secured by readily marketable securities. *See* 12 USC 84 (a); 12 CFR 32.3 (a). A “borrower” includes a person who is named a borrower or debtor in a loan or extension of credit. 12 CFR 32.2(a). Also, loans or extensions of credit to one borrower will be attributed to another person and each person will be deemed a borrower (1) when the proceeds are used for the *direct benefit* of the other person, or (2) when a *common enterprise* is deemed to exist between the persons. *See* 12 CFR 32.5 (a).

The proceeds of a loan or an extension of credit to a borrower will be deemed to be used for the *direct benefit* of another person and will be attributed to the other person when the proceeds, or assets purchased with the proceeds, are transferred to another person, other than in a bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services. *See* 12 CFR 32.5 (b).

A *common enterprise* will be deemed to exist and loans to separate borrowers will be aggregated when:

1) the expected source of repayment for each loan is the same and neither borrower has another source of income from which the loan and the borrower's other obligations can be repaid;

2) the borrowers are related through common control and there is substantial financial interdependence between or among the borrowers;

3) the borrowers use the loan proceeds to acquire a business enterprise of which those borrowers will own more than 50 percent of the voting securities or voting interests of that enterprise;

4) the OCC determines that a common enterprise exists based on the facts and circumstances of a particular transaction.

See 12 CFR 32.5 (c). Thus in determining whether a loan to one borrower should be attributed to another borrower for lending limit purposes, one must apply each of the five loan combination/attribution tests set forth above—the direct benefit test and the four common enterprise tests—to the specific facts of each loan relationship.

Conclusion

Direct Benefit

In determining the applicability of the "direct benefit" test under 12 CFR 32.5(b), the OCC has long considered an equity investment in a company to be a direct benefit to that company, since the equity investment, at a minimum, provides the company with additional working capital. In this case the loan proceeds represented the initial working capital for this newly formed business and while this was a bonafide transaction, there was no property, goods, or services acquired from the company. Given these facts, the ombudsman found the provisions of the 12 CFR 32.5(b) and the precedent letters relied on in citing the violation of 12 USC 84 in the ROE were applicable to this case and appropriately applied.

Common Enterprise

The four tests for common enterprise under 12 CFR 32.5(c) are independent of one another. That is, all four tests do not have to be met to determine that a common enterprise exists, if one test is met then a common enterprise is deemed to exist. While in some scenarios, independent sources of repayment prevent combining loans to different borrowers, in this case, the individual financial capacity of the six borrowers was not relevant to the violation cited in the ROE.

The operating agreement, referenced in the appeal, designated two of the six borrowers as managers and empowered them to act extensively in a decision-making capacity. The agreement also provided all owners of the company with voting authority for certain actions. The voting privileges specified in the operating agreement were associated with the individuals' percentage of ownership interest in the company, in that an affirmative vote from a certain percentage of the ownership interest was required for passage. Therefore, it is reasonable to conclude that the borrowers' investment in the company was commensurate with their voting interest.

The appeal did not dispute that the six borrowers used the borrowed funds to acquire the business enterprise and collectively owned 100 percent of the company. Considering the conclusion reached regarding voting interest of the six owners based on the operating agreement, the ombudsman determined the criteria for "common enterprise" under 12 CFR 32.5(c)(3) was applicable to this case. The combined ownership of the six individuals that borrowed to invest in the company exceeded the 50 percent voting interest threshold in the regulation. Based on these facts, the ombudsman confirmed that a "common enterprise" exists and the precedent letters relied on in that determination was appropriate. Therefore, the ombudsman did not reverse the citing of the violation of the bank's legal lending limit under 12 USC 84.

Appeal of Potential Violation of the Equal Credit Opportunity Act and the Fair Housing Act—Lending Examination Conclusion

Background

A large bank filed a formal appeal concerning a potential violation of the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHAct). The bank received correspondence stating that the OCC had a reason to believe that the bank had engaged in a pattern or practice of discrimination by treating black applicants for home improvement loans less favorably than similarly situated white applicants. The bank did not agree that it engaged in a pattern or practice of discrimination and that a violation of the ECOA and the FHAct occurred.

1) The bank believed that the OCC's decision was based solely upon the results of a multivariate regression analysis. The bank asserted that the multivariate analysis ignored the results of the OCC's univariate analyses and comparative file review, along with the two bank prepared statistical analyses. The two bank-prepared analyses concluded there was no discrimination.

2) The bank also believed that the statistical regression analysis was flawed because the OCC model:
    - contained several fundamental errors that if corrected would eliminate the inference of discrimination;
    - did not include two key underwriting factors;
    - over sampled denied minority applicants based on the reason for denial rather than using an appropriate sample of the population of applications for analysis;
    - did not show either credible exception files nor similarly-situated matches; and
    - did not reach statistical significance at the 95 percent level of confidence when one minority application was extracted from the analysis.

3) The bank asserted that the OCC relied solely on a multivariate regression analysis, which is inconsistent with its fair lending examination procedures and its published agency staff commentary on appropriate examination practices.

4) The bank felt that the OCC finding directly conflicted with safety and soundness considerations.

5) Finally, the bank was of the opinion that the OCC had not provided the bank any comparably unqualified white applicants who received credit.

To evaluate the bank's fair lending performance, the OCC conducted a comparative file analysis and univariate and multivariate regression analyses using statistical modeling. The file analysis compared the treatment of black and white applicants for home improvement loans. The regression model also compared the treatment of black and white applicants. In this case, the findings of the comparative file review were inconclusive, yet the OCC was still troubled by inconsistencies noted with loan outcomes among white and black applicants.

The bank used credit scoring in its loan decision process. However, since bank underwriters did not strictly adhere to the credit score analysis, nor written underwriting guidelines for credit scoring and used multiple and varying criteria for making approval/denial decisions, the OCC concluded that statistical sampling and modeling was the most beneficial way to address the concerns identified during the comparative file review. The multivariate regression analysis revealed that, after consideration of other factors, race was a significant factor in the probability of denial of credit-scored home improvement loan applicants. The analysis indicated that black applicants were approximately four times more likely to be denied credit than similarly situated white applicants. It was determined that a pattern or practice of discrimination may exist as black applicants appeared less favorably treated than similarly qualified white applicants.

The bank hired an outside consultant to conduct its own statistical regression analysis. The bank's consultant contended that the OCC multivariate regression analysis was flawed and should be discounted. The consultant also performed its own regression analysis, using a different approach, and concluded that there was no potential discrimination.

After evaluating all the evidence, including the bank-prepared statistical analyses and several bank responses, the OCC concluded there remained a reason to believe that the bank had potentially engaged in a pattern or practice of discrimination by treating black applicants less favorably than similarly situated white applicants for home improvement loans. Therefore, the OCC concluded it was obligated to refer this matter to the U.S. Department of Justice and to notify the U.S. Department of Housing and Urban Development.

Discussion

The ECOA, 15 USC 1691(a), prohibits a creditor from discriminating against an applicant on a prohibited basis regarding any aspect of a credit transaction. The implementing regulation 12 CFR 202 (Regulation B) defines prohibited basis as:

> *Prohibited basis* means race, color, religion, national origin, sex, marital status, or age (provided that the applicant has the capacity to enter into a binding contract); the fact that all

> or part of the applicant's income derives from any public assistance program; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act or any state law upon which an exemption has been granted by the Board. (12 CFR 202.2 (z))

The FHAct, 42 USC 3605(a), prohibits a lender from discriminating on a prohibited basis in a residential real-estate-related transaction (including the making of loans) or in the terms or conditions of the transaction. The implementing regulation, 24 CFR 100.130, states it shall be unlawful for any person or entity engaged in the making of loans or on the provision of other financial assistance relating to the purchase, construction, improvement, repair, or maintenance of dwellings, or which are secured by residential real estate, to impose different terms or conditions for the availability of such loans or other financial assistance because of, among other factors, race.

While the ECOA and the FHAct do not define the term "pattern or practice," the Interagency Policy Statement on Discrimination in Lending offers guidance on the meaning of a pattern or practice. The policy statement states that "repeated, intentional, regular, usual, deliberate, or institutionalized practices will almost always constitute a pattern or practice" of lending discrimination but "isolated, unrelated, or accidental occurrences will not." In assessing whether a pattern or practice exists, the OCC considers the totality of the circumstances, including the following factors:

- Whether the conduct appears to be grounded in a written or unwritten policy or established practice that is discriminatory in purpose or effect.
- Whether there is evidence of similar conduct by a bank toward more than one applicant.
- Whether the conduct has some common source or cause within the bank's control.
- The relationship of the instances of conduct to one another.
- The relationship of the number of instances of conduct to the bank's total lending activity.

This list of factors is not exhaustive and whether the OCC finds evidence of a pattern or practice depends on the egregiousness of the facts and circumstances involved. Each inquiry is intensively fact-specific and there is no minimum number of violations that will trigger a finding of a pattern or practice of discrimination.

Conclusion

The ombudsman thoroughly reviewed the issues highlighted in the appeal letter, OCC documents and analyses of the issues raised, both prior and subsequent to the appeal submission. Discussions were held with the bank's outside attorney, bank personnel, and appropriate OCC staff.

The ombudsman acknowledged the bank's arguments, but was not persuaded that the supervisory office conclusion was in error or that the OCC statistical sampling and modeling techniques lacked integrity. Therefore, the ombudsman concluded that sufficient information existed to support the examination conclusion that there was a reason to believe that the bank engaged in a pattern or practice of discrimination in violation of the ECOA and the FHAct, and as such, remanded to the OCC's supervisory office the matter of referral to the U.S. Department of Justice and notification to the U.S. Department of Housing and Urban Development.

The ombudsman also addressed the bank's concern regarding the conduct and planning of the examination. While the examination took significantly longer than it should have and contributed to misunderstandings and questions regarding OCC examination goals and objectives, the ombudsman found that both the bank and the OCC were responsible for the time it had taken to complete this examination.

Appeal of a Potential Violation of the Equal Credit Opportunity Act: Disparate Treatment on the Basis of Marital Status

Background

A bank appealed the OCC's decision that there was reason to believe the bank had engaged in a pattern or practice of discouraging or denying credit card applications on the basis of marital status in violation of the Equal Credit Opportunity Act (ECOA). Specifically, the OCC concluded that the bank impermissibly discriminated against credit card applicants on the basis of marital status:

1. By using the phrase "Name of Spouse for Joint Applications" on credit card pre-approved materials;
2. By permitting only the addressee or the addressee's spouse to accept the pre-approved credit card account by telephone;
3. By permitting only the spouse of a deceased credit cardholder to assume the credit card account without reapplication; and
4. By permitting only the spouse of a store employee to be a joint applicant for the store employee credit card.

The bank appealed the OCC's decision based on the following:

- Their sole business is granting credit to all qualified applicants. It defies logic that management would have taken any action to deny credit or discourage any applicant for credit.
- It is incontrovertible as a matter of law that the ECOA and Regulation B are not applicable to the type of solicitations at issue in this case.
- The OCC's position with respect to the bank's handling of deceased accounts is not only flawed as a matter of law, it evidences an alarming lack of understanding of the very real issues confronted by a service organization in trying to deal with the pressing needs of its customers.
- The House Account is an employee benefit under federal tax law—not a credit transaction—and is therefore simply not subject to the ECOA.

The OCC has not identified one instance where any individual was denied credit, or was discouraged from applying for credit, or even complained about the bank's solicitation or application practices. Nor did the OCC provided any evidence that the matters identified in OCC's letter constituted a "pattern or practice."

Discussion

The ECOA, 15 USC 1691(a), prohibits a creditor from discriminating against an applicant on a prohibited basis regarding any aspect of a credit transaction. The implementing regulation 12 CFR 202.4 (Regulation B) defines prohibited basis as follows:

> *Prohibited basis* means race, color, religion, national origin, sex, marital status, or age (provided that the applicant has the capacity to enter into a binding contract); the fact that all or part of the applicant's income derives from any public assistance program; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act or any state law upon which an exemption has been granted by the Board. (12 CFR 202.2 (z))

While ECOA does not define the term "pattern or practice" the Interagency Policy Statement on Discrimination in Lending offers guidance on the meaning of a pattern or practice. The Policy Statement states that "repeated, intentional, regular, usual, deliberate, or institutionalized practices will almost always constitute a pattern or practice" of lending discrimination but "isolated, unrelated, or accidental occurrences will not." In assessing whether a pattern or practice exists, the OCC considers the totality of circumstances, including the following factors:

- Whether the conduct appears to be grounded in a written or unwritten policy or established practice that is discriminatory in purpose or effect.
- Whether there is evidence of similar conduct by a bank toward more than one applicant.
- Whether the conduct has some common source or cause within the bank's control.
- The relationship of the instances of conduct to one another.
- The relationship of the number of instances of conduct to the bank's total lending activity.

This list of factors is not exhaustive and whether the OCC finds evidence of a pattern or practice depends on the egregiousness of the facts and circumstances involved. Each inquiry is intensively fact-specific and there is no minimum number of violations that will trigger a finding of a pattern or practice of discrimination.

Conclusion

The use of the phrase "Name of Spouse for Joint Applications" on pre-approved materials impermissibly discourages unmarried applicants from applying for credit. The bank has argued that this practice is not covered under the regulation because it is a solicitation, and not an application. However, the discussion of whether the pre-approved materials are applications or solicitations becomes a moot issue when considering section 202.5—Rules Concerning Taking of Applications of the Regulation B Commentary:

> 5(a) Discouraging applications.
>
> 1. Potential applicants. Generally, the regulation's protections apply only to persons who have requested or received an extension of credit. In keeping with the purpose of the act—to promote the availability of credit on a nondiscriminatory basis, section 202.5(a) covers acts or practices directed at potential applicants. Practices prohibited by this section include:
>
>   - A statement that the applicant should not bother to apply, after the applicant states that he is retired.
>   - Use of words, symbols, models, or other forms of communication in advertising that express, imply, or suggest a discriminatory preference of a policy of exclusion in violation of the act.
>   - Use of interview scripts that discourage applications on a prohibited basis.

As noted in the second bullet point, the use of any forms of communication in advertising that express, imply, or suggest a discriminatory preference of exclusion results in a violation of the act. The use of materials that contain the phrase "Name of Spouse for Joint Applications" might discourage unmarried persons from applying for joint credit.

As noted in the third bullet point above, the use of interview scripts that discourage applications on a prohibitive basis results in a violation of the act. The practice of permitting either the addressee of a written pre-approved solicitation or the addressee's spouse, but no one else, to accept the credit card account by telephone may impermissibly deny unmarried persons from accepting the account.

While sympathetic to issues involving deceased cardholders, the bank's practice of permitting only the spouse of a deceased cardholder to assume the account without reapplication may impermissibly deny unmarried persons from assuming the account.

The provisions of Regulation B do not exclude credit transaction accounts offered by employers. The bank's practice of permitting only the spouse of its employees to be a joint applicant for the employee credit card may impermissibly deny unmarried person from applying for the account.

Because of the nature of the violations in this case, it is difficult to identify victims. The lack of identifiable victims, however, is not inconsistent with a finding by the OCC that it has reason to believe that the creditor engaged in a pattern or practice of discouraging or denying applications for credit in violation of ECOA.

Based on the above, the ombudsman opined, that at the time of the examination, there was reason to believe that the bank engaged in a pattern or practice of discouraging or denying credit card applications on the basis of marital status.

Appeal of Sensitivity to Market Risk Component Rating and Violations of 12 USC 375(b)

The ombudsman received a formal appeal concerning the Sensitivity to Market Risk component rating and several violations of 12 USC 375 (b)—Extension of Credit to Executive Officers, Directors, and Principal Shareholders of Member Banks.

Sensitivity Rating

Background

Bank management and the board stated that while the Report of Examination (ROE) concludes that interest rate risk is "high and stable," they believed that interest rate risk was not high and was decreasing. The board believed the downgrade in the sensitivity rating from a 2 to a 3 rating was not appropriate. The bank's submission noted that the risk profile of the bank was actually better than at the prior examination and that interest rate risk was incorrectly evaluated as being high. The appeal also noted that the supervisory office did not consider additional information provided during the examination and that peer standards for sensitivity assessment are not clear.

The supervisory office concluded in the ROE that the option features in the bank's funding sources and investments contributed to the complexity and high quantity of risk, which warranted strong risk management systems. The ROE further stated that management of interest rate risk was weak because effective risk limits or board reporting processes were not in place and senior management did not effectively measure and monitor the risk. The previous ROE suggested that management obtain periodic stress testing reports to better gauge the potential impact of their decisions.

Discussion

In accordance with OCC Bulletin 97–1 ("Uniform Financial Institutions Rating System"), the sensitivity to market risk rating is intended to reflect the degree to which changes in interest rates can adversely affect the earnings and capital of a financial institution. Primary considerations in determining the sensitivity rating are management's ability to identify, measure, monitor, and control market risk, the nature and complexity of the institution's activities, and the adequacy of the capital and earnings in relation to level of market risk.

In discussion with bank management and the supervisory office, there was a consensus that the bank had a significant level of interest-sensitive assets and liabilities at the time of the examination. Adding to the complexity of the balance sheet, several of the asset and liability categories had features (embedded options, caps and floors, etc.) that increase or decrease the level of risk in a changing rate environment. When these conditions are present, it is critical that risk management processes accurately identify, measure, monitor, and control the risk.

As a result of recommendations made in the previous ROE, management had improved the bank's risk management process, specifically by measuring the effects of interest rate shocks on the balance sheet. However, the assumptions associated with this modeling were not well supported and hindered an accurate assessment of the risk. Management did not initiate changes to the assumptions until the examination. In addition, the model did not provide the degree of sophistication required to capture the risk, given the complexity of the balance sheet. Finally, risk management limits were not appropriately defined and board minutes did not reflect discussion of the issues associated with interest rate risk.

Conclusion

At the time of the examination, the bank had a significant level of repricing and options risk in its balance sheet. There was a concern that the level of earnings and capital would not adequately support the degree of market risk present, particularly when considering the increased level of credit risk from the bank's lending activities. While management had taken steps to strengthen the tools used to measure the impact of interest rate risk, the modeling weaknesses identified during the examination warranted further action. Therefore, the ombudsman concluded that the 3 rating assigned during the examination was appropriate.

Regulation O/Insider Lending Violations

Background

Bank management and the board believed that several violations of the implementing regulation 12 CFR 215 (Regulation O) was subjective in nature and should not be included in the ROE. Specifically, they disagreed with the violations citing preferential terms on loans to insiders. Bank management believed that several items cited as violations of Regulation O/Insider Loans were based on subjective judgment and should not be included as "violations of law" in the ROE. Management believed the violations of law that were cited in the ROE were either technical in nature or based on a subjective standard that bank management disagreed with in each case. The bank stated they have never given preference to directors or principal shareholders on credit facilities.

The ROE identified eight violations of Regulation O where extensions of credit were granted on favorable terms. These included pricing, waiving of fees, and policy exceptions for a borrower's equity in real property. The ROE comments further explained that these violations were technical because management could not provide transactions considered comparable by the OCC.

Discussion

Regulation O, 12 CFR 215—Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, section 215.4(a)(1)(i), states.

> (1) No member bank may extend credit to any insider of a bank or insider of its affiliates unless the extension of credit:
>
> (i) Is made on substantially the same terms (including interest rates and collateral) as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with other persons that are not covered by this part and who are not employed by the bank; and
>
> (ii) Does not involve more than the normal risk of repayment or present unfavorable features.

The ROE criticized bank management for failing to provide comparable transactions to the insider loans cited for preferential terms. The ombudsman's review revealed that some of the loans provided as comparable transactions were similar to the insider loans, but there were nuances that differentiated the transactions and created questions regarding their comparability. Additionally, the review of the applicable loan profitability worksheets found that they did not include all aspects of the customer's relationship with the bank. In some instances, the deposit relationship was the factor that lent support to the terms given to the insiders but it was not included in the profitability worksheet.

Conclusion

The ROE specifically concluded that the lack of comparable transactions was a technical violation because "the applicable insiders do have substantial net worth and liquidity and may warrant 'best borrower' rates." This description is more reflective of a violation of 12 CFR 215.8 (a), which states:

> (a) *In general*. Each member bank shall maintain records necessary for compliance with the requirements of this part.

Based on the comments in the ROE and the information provided by bank management, the ombudsman concluded that the preferential treatment violation cited in the ROE was not appropriate. However, bank management's inadequate documentation did not clearly demonstrate compliance with the prohibition against preferential lending to insiders. Therefore the ombudsman concluded that the lack of documentation to demonstrate compliance was a violation of 12 CFR 215.8.

Appeal of an Insider Violation for Preferential Treatment

Background

A bank appealed a violation of 12 USC 375b and 12 CFR 215.4(a)(1)(i) cited in the bank's Report of Examination (ROE) in connection with a loan extended by the bank to a director. Bank management believed the facts associated with the transaction did not represent preferential terms on the credit extended to the insider.

The transaction involved the refinancing of an automobile loan from the insider's business to the insider personally. The loan to the business was at the bank's prime rate for commercial customers plus 100 basis points and was structured on an interest-only time/demand note. When the loan was refinanced into the individual's name, the borrower paid down over 40 percent of the outstanding balance, and received the going installment loan rate for a 48 month auto loan, approximately 200 basis points less than the previous loan. However, the loan was left on an interest-only time/demand note, maturing in 12 months with quarterly interest payments. An analysis of the financial information supported the borrower's credit worthiness with minimum debt, strong net worth, and good liquidity.

The bank's rate sheet detailed separate rates for loans structured on an installment basis versus those on a time/demand basis. The supervisory office cited the violation because management granted the lower installment loan rate for a loan secured by a 1999 automobile for a 48 month term, not the higher time/demand rate listed on the bank's rate sheet. The supervisory office position was that an installment loan rate should only be applicable for loans actually on an installment basis with monthly or quarterly principal and interest payments. During the examination, bank management was not able to provide any acceptable transactions that were comparable in pricing and structure to demonstrate that the terms extended to the director were also available to other non-insider customers of the bank.

Discussion

Regulation O, 12 CFR 215, "Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks," section 215.4(a)(1)(i), states:

> (1) No member bank may extend credit to any insider of a bank or insider of its affiliates unless the extension of credit:
>
> > (i) Is made on substantially the same terms (including interest rates and collateral) as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with other persons that are not covered by this part and who are not employed by the bank.

The bank provided the ombudsman with an example of a similarly structured loan that was granted to a non-insider to demonstrate that the time/demand structure of the loan was available to other customers of the bank. The ombudsman found the loan to the non-insider was extended before the insider's loan and the pricing methodology and the structure were consistent for both transactions, although other terms varied slightly.

Conclusion

The ombudsman found the bank's loan rate sheet to be ambiguous and determined that it could be interpreted in various ways. It did not clearly specify whether the rate should be based on the collateral or structure. According to the rate sheet:

The rate on personal loans was determined by the collateral, in this case rates for the collateral (1999 vehicle) were 7.50 percent for 36 months, 7.75 percent for 48 months and 7.90 percent for 60 months.

The rate on time/demand loans was prime rate (9.50 percent) plus 50 or 100 basis points, even when secured by deposits in the bank.

As shown above, it would not be clear which rate should be applied on a personal loan, with an automobile as collateral and structured on a time/demand basis.

Considering all the above, the ombudsman did not believe the loan in question represented preferential treatment for an insider and thus it was not a violation of 12 CFR 215.4. While the bank was able to provide a comparable transaction, that was not the basis for the ombudsman's conclusion.

Directors' business and personal dealings with the bank must be structured to comply with legal requirements and to avoid even the appearance of a conflict of interest. The ombudsman encouraged bank management and the board to thoroughly review and revise the bank's rate sheet so that all ambiguities are eliminated.

Accounting Issues

Appeal of OCC's Interpretation of the Risk-Based Capital Treatment of Assigned Residual Interests in Asset Securitizations

Background

A bank formally appealed the OCC's interpretation of the risk-based capital treatment of assigned residual interests in asset securitizations. Specifically, the bank appealed the supervisory office decision that the assignment of a portion of the residual interest would not result in a lower capital charge for the bank on the recourse exposure created by those residuals.

The bank asserted that because the assigned residual interests share in the losses on the underlying loans sold into the securitization, the bank should be permitted to lower its total risk-weighted assets for risk-based capital purposes by a similar proportion. The bank further indicated that the transferred portions of the residuals creating the recourse obligation to third parties is structured in a manner that assures a pro-rata sharing of all risk and losses. In support of this contention, the bank refers to the glossary section of the March 1998 Call Report Instructions under the heading, "Sales of Assets for Risk-Based Capital Purposes" (p. A–72). The instructions state the following:

> However, if the risk retained by the seller is limited to *some fixed percentage of any losses* that might be incurred and there are no other provisions resulting in retention of risk, either directly or indirectly, by the seller, the maximum amount of possible loss for which the selling bank is at risk (the stated percentage times the amount of assets to which the percentage applies) is subject to risk-based capital and reportable in Schedule RC–R and the remaining amount of the assets transferred would be treated as a sale that is not subject to the risk-based capital requirements. For example, a seller would treat a sale of $1 million in assets, with a recourse provision that the seller and buyer proportionately share in losses incurred on a ten percent and 90 percent basis, and with no other retention of risk by the seller, as a $100 thousand asset sale with recourse and a $900 thousand sale not subject to risk-based capital.

Discussion

The OCC's interpretation was that the bank's assignment of a portion of its retained residual interest in securitization transactions should not result in a reduction of the bank's overall level of required capital. As a class, both the assigned and retained residual interests are wholly subordinate to the claims of certificate holders, and there is no pro-rata loss sharing with those senior interests. The bank has not sufficiently limited its losses to a fixed percentage of losses on the underlying loans. Consequently, the full amount of underlying loans are considered sold with recourse, and should be included in the bank's calculation of risk-weighted assets.

In order to appropriately resolve the issues identified in the appeal, it was essential that the ombudsman consider them in the context of on-going interagency capital policy deliberations and the resolution of similar issues with other institutions. An interagency working group was scheduled to review this issue at their next meeting.

Conclusion

Until such time as a joint interagency decision was reached on the underlying issues, the ombudsman opted to permit the bank to continue its current risk-based capital treatment. The bank's treatment reduced the capital requirement in proportion to the percentage of the residuals assigned to third parties.

The bank was to be informed when the agencies reached a final decision, and of any risk-based capital adjustments, which may be necessary.

Subsequent Event

The Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the OCC reviewed this policy issue, and reached a consensus that conforms to the OCC's original interpretation as conveyed to the bank. This consensus reaffirms that when a bank retains risk of credit loss in connection with a transfer of assets, those assets must be included in the bank's calculation of risk-weighted assets, subject to the low-level recourse rule. Notwithstanding the assignment of a portion of a residual interest in a securitization, the retained residual interest continues to give rise to a concentration of credit risk, relative to the underlying pool, for which the recourse capital requirement remains appropriate.

Consequently, for each pool of securitized loans, the banks should hold risk-based capital equal to the lesser of (a) 8 percent of the risk weighted amounts of the outstanding loans in the pool, or (b) the bank's maximum loss in the event the entire pool of loans defaulted. For this purpose, the bank's maximum loss exposure includes the book value (determined under GAAP) of any interest it holds in the pool, as well as any contractual obligation to reimburse the pool or investors for losses in the pool. If the bank's maximum loss exposure exceeds 8 percent of a pool's risk-weighted assets, the full amount of the underlying loans are considered sold with recourse and should be included in the bank's calculation of risk-weighted assets. However, should the bank's maximum loss exposure fall below 8 percent of the risk-weighted amount of the outstanding loan balances in the pool, the position would be eligible for more advantageous treatment under the low-level recourse rule.

The bank was informed of this decision.

OCC 2002-9

OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: National Bank Appeals Process   Description: Guidance for Bankers

TO: Chief Executive Officers of All National Banks, Federal Branches and Agencies, Department and Division Heads, and All Examining Personnel

PURPOSE

This issuance revises the Office of the Comptroller of the Currency's procedures for national banks to appeal agency decisions and actions. It replaces Banking Bulletin 96-18 (REV), dated February 23, 1996.[1]

POLICY

The Office of the Comptroller of the Currency (OCC) is responsible for fostering the safety and soundness of the national banking system and for monitoring and enforcing national banks' compliance with laws and regulations. It is also responsible for encouraging competitiveness, integrity, and stability of financial services provided by the national banking system. In fulfilling this mission, the OCC maintains open and ongoing communication with both the institutions it supervises and certain affected persons. The agency also fosters the fair and equitable administration of the supervisory process.

The OCC ombudsman functions *outside* the bank supervision area and reports directly to the Comptroller of the Currency. With the prior consent of the Comptroller, the ombudsman may stay any appealable agency decision or action during the resolution of an appealable matter. The ombudsman also may report weaknesses in OCC policy to the Comptroller, and may make recommendations regarding changes in OCC policy. The existence of a formal national bank appeals process does not change the core philosophy of the OCC concerning dispute resolution. The agency remains committed to making every effort to resolve disputes arising during the supervisory process fairly and expeditiously, in an amicable, *informal* manner.

[1] 12 USC 4806 required the OCC, Office of Thrift Supervision, Federal Deposit Insurance Corporation, Federal Reserve Board, and the National Credit Union Administration to establish an intra-agency appellate process for the review of "material supervisory determinations" made by agency officials. On February 23, 1996, the OCC issued Banking Bulletin 96-18 containing guidance on the types of determinations that are eligible for review and the process by which appeals are considered and decided by the OCC.

National banks and federal branches and agencies of foreign banks (collectively referred to as "national banks" for the purpose of this issuance) are encouraged to contact the ombudsman to discuss any agency policy, decision, or action that might develop into an appealable matter. The ombudsman's objective in these cases is to seek an agreeable resolution to the dispute *before* it develops into a formal appeal. This avenue provides an opportunity for national banks to resolve issues in the most efficient and expeditious manner possible.

If national banks cannot resolve disagreements through informal discussions, they are encouraged to seek a further review of the OCC decisions or actions that are in dispute. The OCC official involved in the dispute should inform the bank of the formal appeals process.

This issuance establishes the process through which a national bank can seek such a review of agency decisions and actions. These procedures also ensure that no one is disadvantaged by filing an appeal. If a national bank questions whether it should make use of this appeal authority, it should contact the ombudsman. If called on, the ombudsman is available to act as a liaison between the OCC and *any* affected person with respect to any problem such a person may have in dealing with the OCC resulting from its regulatory activities. Interested parties should direct all communications with the ombudsman to the following address:

Office of the Ombudsman
1301 McKinney Street, Suite 3725
Houston, Texas 77010-3034
Phone: (713) 336-4350, Fax: (713) 336-4351

PROCEDURES

Appealable Matters

Except as otherwise provided below, a national bank may seek a review of any agency decision or action, including (1) examination ratings (2) adequacy of loan loss reserve provisions and (3) classifications of loans that are significant to an institution.

A national bank may *not* appeal to the ombudsman or its immediate OCC supervisory office:

1) Appointments of receivers and conservators;

2) Preliminary examination conclusions communicated to the national bank before a final report of examination or other written communication from the OCC is issued (although a national bank is **encouraged** to discuss any concerns or disagreements regarding these conclusions with its examiner-in-charge (EIC) or its supervisory office);

3) Any formal enforcement-related actions or decisions,[2] including decisions to: (a) seek the issuance of a formal agreement or cease and desist order, or the assessment of a civil money

[2] For purposes of this bulletin, a formal enforcement-related action or decision includes the underlying facts that form the basis of a recommended or pending formal enforcement action, the acts or practices that are the subject of a pending formal enforcement action, and OCC determinations regarding compliance with an existing formal enforcement action.

penalty pursuant to Section 8 of the Federal Deposit Insurance Act (FDIA); (b) take prompt corrective action pursuant to Section 38 of the 12 USC 1831o); (c) issue a safety and soundness order pursuant to Section 39 of the FDIA (12 USC 1831p-1); and (d) commence formal investigations pursuant to 12 USC 481, 1818(n) and 1820(c);

4) Formal and informal rulemakings pursuant to the Administrative Procedure Act (APA), 5 USC 500 *et seq*.;

5) Decisions or recommended decisions following formal and informal adjudications conducted pursuant to the APA, 5 USC 701 et seq.;

6) Requests for agency records or information under, and submission of information to the OCC that are governed by, the Freedom of Information Act, 5 USC 552, or 12 CFR 4;

7) Decisions made to disapprove directors and senior executive officers pursuant to Section 914 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) (12 USC 1831i); and

8) Any other agency decisions that are subject to judicial review.

A formal enforcement-related action or decision commences when a Supervision Review Committee determines that the OCC will pursue a formal action under applicable statutes, regulations, or published enforcement-related policies of the OCC, and at that point becomes unappealable. Such policies include the OCC's Policy for Corrective Action (PPM 5310-3 (REV)), Civil Money Penalty Policy (PPM 5000-7 (REV)), and Securities Enforcement Policy (PPM 5310-5). These policies are available on request from the OCC's Communications Division, 250 E Street, SW, Washington, DC 20219-0001, or by telephone at (202) 874-4700. For purposes of this issuance only, remarks in a report of examination and other communications about a potential formal enforcement action made prior to a Supervision Review Committee decision are preliminary and, therefore, unappealable.

Filing an Appeal

A national bank may seek review of appealable matters by filing an appeal with *either* the ombudsman or the bank's immediate OCC supervisory office. Except as otherwise provided in the process for appealing Shared National Credit (SNC) decisions and fair-lending-related matters, all appealable matters can be received in either location. The choice of where to file is left to the discretion of the bank, with a few exceptions. The procedures for filing an appeal under these options are outlined below:

- **Appeals to the Ombudsman.** Formal appeals to the ombudsman may arise from two sources: (1) appeals filed directly with the ombudsman, or (2) second-tier appeals of supervisory office appeal decisions and decisions rendered under one of the appeals procedures designed specifically for the issue in dispute (fair-lending-related appeals and SNC appeals).

[3] These policies and procedures are not intended to, do not, and may not be relied upon to create rights, substantive or procedural, enforceable at law or in any administrative proceeding.

– ***Appeals Directly to the Ombudsman:*** National banks filing appeals with the ombudsman should submit information in writing fully describing the matter in dispute. To ensure that the bank's board of directors supports the appeal, the president or chief executive officer must submit a bank's appeal, and disclose in the submission the board's approval of the action. When the ombudsman receives an appeal, he or she will contact the OCC management official(s) involved in the dispute. That management official(s) will submit written materials and relevant OCC documents pertaining to the appeal within 10 calendar days of the notice from the ombudsman. The ombudsman will contact the bank to ensure that the OCC has all relevant materials. If requested by either the OCC management involved in the dispute or a senior bank official, the ombudsman will arrange a meeting or a telephone call to more fully discuss the issues to be addressed in the appeal and any related matters. In the absence of any extenuating circumstances, the ombudsman will issue a written response to the appeal within 45 calendar days of accepting an appeal.

– ***Second-Tier Appeals:*** If a national bank *disagrees* with the decision rendered through a supervisory office appeal or a decision rendered under one of the specifically designated appeals procedures, the bank may further appeal the matter to the ombudsman. The bank must file written notice of this second-tier appeal within 30 calendar days of receiving the appeal decision letter from the appropriate deputy.

When the ombudsman receives the second-tier appeal, he or she shall review any material considered in the preparation of the initial appeal response, including information submitted by the appellant at the time of the first-tier (supervisory office) appeal, and any other information considered by the OCC management official in making the initial appeal decision. The ombudsman will contact the national bank to ensure that the OCC is in possession of all relevant material. If requested by either OCC management involved in the appeal or a senior official of the national bank filing the appeal, the ombudsman will arrange a meeting or a telephone call to more fully discuss issues to be addressed in the appeal and related matters. In the absence of any extenuating circumstances, the ombudsman will issue a written response to the second-tier appeal within 30 calendar days of the filing of that appeal.

– ***Recusal of the Ombudsman:*** In cases where the ombudsman should be recused from reviewing the decision under appeal, the ombudsman will transfer the appeal to a senior official designated by the Comptroller.

- **Supervisory Office Appeals.** Supervisory office appeals should be filed with the deputy comptroller representing the OCC supervisory office that supervises the bank. Community banks and mid-size banks should file such appeals with the deputy comptroller of the OCC district in which the bank is headquartered. Banks in Large Bank Supervision and Special Supervision programs using this option should file appeals with the appropriate deputy comptroller in the Washington office. National banks that choose not to file appeals of corporate decisions directly with the ombudsman should file with the deputy comptroller for Licensing.

National banks filing supervisory office appeals should submit information in writing fully describing the matter in dispute and setting forth their bases for requesting an appeal. Upon receipt of an appeal, a supervisory office official will contact the OCC employee(s) involved in the matter under appeal. The supervisory office official includes the appropriate deputy comptroller, or a designee who has not directly or indirectly participated in making the decision in dispute. The supervisory office official also should not be directly or indirectly responsible to the agency official who made the decision under review. The OCC employee(s) will submit written or oral information concerning the facts or circumstances resulting in the decision being appealed. If requested by a senior official of the national bank filing the appeal, the appropriate deputy comptroller will arrange a meeting or a telephone call to more fully discuss the issues to be addressed in the appeal and related matters.

In the absence of any extenuating circumstances, the appropriate deputy comptroller will issue an appeal decision letter within 45 calendar days of accepting the appeal. Immediately after issuing a decision letter, the deputy comptroller will forward to the ombudsman copies of all relevant materials considered in the preparation of the decision letter, including all written submissions by the bank.

If the national bank *disagrees* with the response from the deputy comptroller, a senior official of the bank may further appeal the matter to the ombudsman. The appeal decision letter from the deputy comptroller to the bank will notify the bank of this option. The bank must file written notice of this second-tier appeal within 30 calendar days of receiving the appeal decision letter from the appropriate deputy comptroller.

– ***Recusal of the Deputy Comptroller:*** In cases where the deputy comptroller directly or indirectly participated in making the decision under review, he or she must transfer the appeal to the ombudsman after advising the appellant. The same is true if he or she directly or indirectly reports to the agency official who made the decision under review.

- **Fair-Lending-Related Matters.** When the OCC has made a determination that there is reason to believe an instance or pattern or practice of discrimination exists that will result in either a referral to the Department of Justice or notification to the Department of Housing and Urban Development, the senior deputy comptroller for Mid-Size and Community Bank Supervision or the senior deputy comptroller for Large Bank Supervision (whichever oversees the bank) will provide written notice to the bank of this finding. National banks may file an appeal to the ombudsman for reconsideration of this decision within 15 calendar days of the date of this letter.

- **Shared National Credits.** Bank senior management should notify the EIC assigned to the bank if it disagrees significantly with a decision rendered through the SNC program. If the bank and the examining team are unable to resolve the disagreement through *informal* discussions, the bank may appeal the decision to the appropriate deputy comptroller for Large Bank Supervision.

– ***Who May Submit a SNC Appeal:*** A SNC appeal may be submitted by the agent bank directly, or on behalf of any of the participating national banks. If the agent bank refuses, for whatever reason, to file the appeal on behalf of the bank group, Large Bank Supervision will accept an appeal from any *one* participating bank. Banks must file SNC appeals with the regulator that supervises the agent bank. Therefore, if a state-member bank is a participant in a credit that is agented by a national bank, the state-member bank must file its appeal with the OCC. Conversely, if a national bank is a participant in a credit for which a state-member bank is agent, the national bank must file its appeal with the Federal Reserve Board. When there is no agent bank named, the appeal should be filed with the regulator that supervises the bank at which the SNC was reviewed. To ensure that the bank's senior management supports the appeal, the chief executive officer (CEO) of the appealing bank must submit all SNC appeals.

– ***Timing of SNC Appeals:*** The agent bank should normally file a SNC appeal within 14 days of notification by the EIC of the preliminary disposition of the credit. Notification is when the EIC gives the bank the preliminary notification letter at the conclusion of the SNC review process. Any *one* participant bank can appeal either through the agent bank, or on its own, within 14 days of receiving the preliminary SNC results from the agent bank. If preliminary results are not provided by the agent bank, participant banks may file an appeal within 14 days of receiving the official SNC results from the primary regulator. Large Bank Supervision will evaluate the reasonableness of appeals delayed by extenuating circumstances on a case-by-case basis. The SNC preliminary notification letter authorizes agent or review banks, at their option, to notify participating banks of the preliminary disposition of each credit.

The report of shared national credits is issued annually to national banks participating in the SNC program at the end of each SNC review. Because of processing deadlines, the report may not reflect decisions on SNC appeals submitted beyond the initial 14-day filing period. In such cases, Large Bank Supervision will send a supplemental letter to each participating institution notifying them of the results of the appeal. The letter will also communicate any necessary revisions to each bank's report of shared national credits.

– ***SNC Appeal Letter:*** In drafting a SNC appeal letter, senior bank management should explain why it disagrees with the SNC decision. The SNC appeal letter must identify the credit, commitment amount, disposition, basis for the bank's disagreement, and any documentation that supports management's position on the matter(s) in dispute. Banks should address all SNC appeals to the appropriate deputy comptroller for Large Bank Supervision, Comptroller of the Currency, Washington, DC 20219.

– ***SNC Appeal Processing:*** Once a SNC appeal is received in the Washington office, the appropriate deputy comptroller for Large Bank Supervision will immediately acknowledge receipt by letter to the CEO of the bank filing the appeal. Large Bank Supervision will normally forward a copy of the appeal letter and supporting information to the voting team within three working days of the receipt date. The voting team will then confirm the accuracy of the facts presented in the appeal letter.

A copy of the appeal letter will also be forwarded to the EIC of the bank. Each individual should provide his or her formal comments and opinions to the appropriate deputy comptroller for Large Bank Supervision within 10 working days after the receipt date. A deputy comptroller for Large Bank Supervision will normally grant requests by bank management for a meeting to discuss the issues in dispute.

An interagency panel consisting of senior credit examiners will evaluate the appeal and make a recommendation to senior management for approval. (Senior management of the appropriate agency has final approval on appeals submitted to them.) Large Bank Supervision will normally conclude the entire SNC appeal process within 30 days of receipt of the appeal. Immediately after issuing a decision letter, the appropriate deputy comptroller for Large Bank Supervision will forward to the ombudsman copies of all relevant materials considered in preparation of the response, including all written submissions by the bank. If a bank *disagrees* with the decision rendered through the SNC appeals process, it may further appeal the matter to the ombudsman. The appeal decision letter from the deputy comptroller to the bank will notify the bank of this option. The bank must file written notice of this second-tier appeal within 30 calendar days of receiving the appeal decision letter from the deputy comptroller for Large Bank Supervision.

For more information concerning the appeal of a SNC decision, please contact the Washington SNC program manager in Large Bank Supervision at (202) 874-4610.

Effect of Filing an Appeal

As a general matter, material supervisory decisions and actions are not stayed during the pursuit of an appeal. In the appropriate circumstances, however, the ombudsman or appropriate OCC official, upon written request of the bank, may relieve the bank of the obligation to comply with a supervisory decision or action while the supervisory appeal is pending.

Follow-up by the Ombudsman

After the appropriate OCC official renders a decision on an appeal, the ombudsman will contact the appellant bank to ask whether the bank believes OCC examiners have taken actions against the bank in retaliation for its appeal. The ombudsman should make these contacts (1) six months after the date of the decision letter, and (2) six months after the date of completion of the first examination of the appellant bank following its appeal. A national bank may, of course, contact the ombudsman any time during or after the appeal if the bank reasonably believes that an OCC official is retaliating against it for its appeal.

Upon identifying or learning of any possible retaliatory actions, the ombudsman will investigate the complaint. In the absence of extenuating circumstances, such investigations will be completed within 30 days. If the ombudsman finds that retaliation has occurred, he or she will forward the complaint to either the senior deputy comptroller for Mid-Size and Community Bank Supervision or the senior deputy comptroller for Large Bank Supervision (whichever oversees the bank), or to the inspector general. These officials will take appropriate action, including disciplinary action consistent with OCC policies and procedures. In addition, to prevent future retaliation for an appeal, the ombudsman may recommend to the Comptroller that the next examination of the national bank exclude personnel involved in a ruling appealed by that bank. The Comptroller will make the final decision on any exclusion.

OCC 2002-9

Liaison Activity of Ombudsman

In addition to hearing and deciding appeals brought by national banks, the ombudsman is available to act as a liaison between the OCC and any affected person(s). Such help may relate to any problem or question the party may have in dealing with the OCC resulting from the OCC's regulatory activities. The ombudsman will either provide the requested information or direct the person to the appropriate point of contact. In so doing, the ombudsman will ensure that safeguards exist to encourage persons to come forward and to preserve the confidentiality of those seeking information or identifying a concern.

Interested parties may also call the OCC's Customer Assistance Hotline, located in the OCC's ombudsman's office, to report any problems or concerns they may have regarding national banks. The toll-free number is 1-800-613-6743. In addition, interested persons may comment on proposed OCC rulemakings published in the *Federal Register* for notice and comment by filing written comments with the OCC, as described in the rulemaking.

John D. Hawke, Jr.
Comptroller of the Currency

APPENDIX 3—Frequently Asked Questions about OCC Bulletin 2002–9, "National Bank Appeals Process: Guidance for Bankers"

OCC Bulletin 2002–9, "National Bank Appeals Process, Guidance for Bankers," dated February 25, 2002, revises the OCC's procedures for national banks to appeal agency decisions and actions. It replaces OCC Bulletin 96–8 (REV) dated February 23, 1996. In conjunction with this bulletin, the OCC also issued PPM 1000–9 (REV) that updates the guidelines for responding to national bank appeals and procedures for administering the appeals process.

1. What Are The Major Differences Between OCC Bulletins 2002-9 and 96-18?

The OCC's Bulletin 2002–9 clarifies and revises OCC Bulletin 96–18 and makes some technical changes to reflect the OCC's current organizational structure. The main clarifications and revisions are discussed below.

Appealable and Non-Appealable Matters

Bulletin 2002–9 clarifies the types of decisions that can be appealed to the ombudsman or the bank's immediate supervisory office by allowing banks to appeal supervisory decisions resulting in informal enforcement actions.

In addition, Bulletin 2002–9 clarifies Bulletin 96–18 to make clear that banks cannot seek ombudsman review of agency decisions for which banks are provided with an appeal mechanism by statute or OCC regulation, or where the decision is subject to judicial review. These include agency decisions to pursue formal enforcement action or recommended decisions following formal or informal adjudications pursuant to the Administrative Procedures Act, 5 USC 701 et seq., agency actions that are subject to judicial review and decisions made to disapprove directors and senior executive officers pursuant to Section 914 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, 12 USC 1831i.

Formal Enforcement-Related Action or Decision Defined

Bulletin 2002–9 also clarifies that "formal enforcement-related actions or decisions" include the underlying facts that form the basis of recommended or pending formal enforcement actions, the acts or practices that are the subject of pending formal enforcement actions and OCC determinations regarding compliance with an existing formal enforcement action. This clarification of the term "enforcement-related decisions" reflects that an enforcement-related decision includes the factual underpinnings of the decision.

Commencement of Formal Enforcement-Related Action or Decision

Bulletin 96–18 provided that when a bank receives notice from the OCC indicating its intention to pursue an enforcement action, the matter is removed from the appeals process. However, Bulletin 96–18 did not specify what type of notice from the OCC was required to remove enforcement actions from the appeals process. In order to achieve agency consistency in the application of this rule and to eliminate confusion as to when a formal enforcement-related action or decision commences and therefore becomes unappealable, Bulletin 2002–9 clarifies that a formal enforcement-related action or decision commences when the OCC's Supervision Review Committee determines that the OCC will pursue a formal action under applicable statutes, regulations, or published OCC enforcement-related policies.

Procedures for Filing an Appeal

Bulletin 2002–9 added language to clarify that in order to ensure that the bank's board of directors supports the appeal, the president or chief executive officer must submit the bank's appeal and disclose in the submission the board's approval of the action.

Effect of Filing an Appeal

Bulletin 2002–9 revised Bulletin 96–18 to provide that as a general matter, material supervisory determinations and actions are not stayed during the pursuit of an appeal. However, upon written request from the bank, the ombudsman or an appropriate OCC official may relieve the bank of its obligation to comply with the supervisory decision or action while the appeal is pending.

2. What Is Appealable?

Material Supervisory Determinations

In accordance with 12 USC 4806, Bulletin 2002–9 provides that agency actions or decisions including examination ratings, the adequacy of loan loss reserve provisions, and classifications of loans that are significant to an institution can be appealed by national banks.

Scope of Review in Formal Enforcement Cases

While Bulletin 2002–9 does not allow appeals of the underlying facts of an enforcement action, it does permit material supervisory determinations to be appealed even when an enforcement action has been taken. For example, a bank that is being placed under formal enforcement action can appeal its CAMELSI ratings (composite or individual components), loan classifications or conclusions rendered on the adequacy of its Allowance for Loan and Lease Losses. In such cases, the ombudsman would restrict his review to the factual record, primarily the facts detailed in the Report of Examination and make a determination on whether the Uniform Financial Institution Rating System criteria or other relevant policies have been applied correctly and consistently by the supervisory office. Essentially, the ombudsman would utilize a process similar to that of a federal appeals judge versus the de-novo review process that is customarily employed on non-enforcement related appellate matters.

3. What Is Not Appealable?

In accordance with 12 USC 4806, Bulletin 2002–9 provides that the following agency actions or decisions are not appealable to the ombudsman or the bank's immediate supervisory office:

1) Appointments of receivers and conservators;
2) Preliminary examination conclusions communicated to the national bank before a final report of examination or other written communication from the OCC is issued;

3) Any formal enforcement-related actions or decisions, including decisions to:

(a) seek the issuance of a formal agreement or cease and desist order, or the assessment of a civil money penalty pursuant to Section 8 of the Federal Deposit Insurance Act (FDIA);

(b) take prompt corrective action pursuant to Section 38 of the 12 USC 1831o);

(c) issue a safety and soundness order pursuant to Section 39 of the FDIA (12 USC 1831p–1); and

(d) commence formal investigations pursuant to 12 USC 481, 1818(n) and 1820(c);

4) Formal and informal rulemakings pursuant to the Administrative Procedure Act (APA), 5 USC 500 et seq.;

5) Decisions or recommended decisions following formal and informal adjudications conducted pursuant to the APA, 5 USC 701 et seq.;

6) Requests for agency records or information under, and submission of information to the OCC that are governed by, the Freedom of Information Act, 5 USC 552, or 12 CFR 4;

7) Decisions made to disapprove directors and senior executive officers pursuant to Section 914 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) (12 USC 1831i); and

8) Any other agency decisions that are subject to judicial review.

APPENDIX 4—Examination Questionnaire Sample

Comptroller of the Currency
Examination Questionnaire

This form is being used to help measure the effectiveness of the overall supervision of your institution, including the examination that was just completed. Your input will help us evaluate the OCC's performance and progress in improving the efficiency and effectiveness of our bank supervision efforts. Please complete the attached questionnaire and return it to Samuel Golden, Ombudsman, the administrator of the program. Your response is **entirely voluntary** and will remain **confidential**. If you would like to discuss this questionnaire, please feel free to contact Samuel Golden at (713) 336-4350.

PAPERWORK REDUCTION ACT STATEMENT FOR EXAMINATION QUESTIONNAIRE

No person is required to respond to an information collection unless it displays a currently valid OMB control number. This information collection is approved under Office of Management and Budget (OMB) Control Number 1557-0199. This information collection is voluntary. This information collection is needed to permit a national bank to provide feedback, directly to the Office of the Ombudsman, Office of the Comptroller of the Currency (OCC Ombudsman), on the content and conduct of OCC bank examinations. The OCC Ombudsman will use the information received to evaluate the effectiveness of the examination process and agency communications. The OCC Ombudsman promotes OCC/banker communications and resolves problems and conflicts.

The OCC expects to collect this information from approximately 2,600 national banks. Each respondent is estimated to file 1.5 responses per year. The burden per response is expected to average approximately 10 minutes. The time for completing the questionnaire will vary. A response may take a very short time if bank management has no descriptive comments, and could take 30 minutes or more in those instances where bank management has substantial descriptive comments. The burden for this collection is estimated at 650 burden hours per year.

OMB Control #1557-0199
Exp: 08-31-2004

Comptroller of the Currency
Examination Questionnaire

Community and Mid-Size Banks

To be filled out by the Examiner-in-Charge:
Type of Examination:

☐ Community Bank ☐ Mid-Size Bank

☐ Commercial ☐ Consumer Compliance ☐ CRA ☐ Fair Lending ☐ Information Technology (IT)
☐ Fiduciary ☐ Federal Branch/Agency ☐ Other (specify)________________________________

Date of Examination: ___________________________

Supervisory Office Location:
☐ Northeastern ☐ Southeastern ☐ Midwestern ☐ Central ☐ Southwestern ☐ Western

To be filled out by bank management:

Name and Position: ____

Bank Name: ____

Telephone Number: ____

Regarding the examination just completed:

	Completely Agree 1	2	Somewhat Agree 3	4	Completely Disagree 5
1. The examination scope was appropriate to accurately assess the bank's condition.	1	2	3	4	5
2. The examiners' requests for information before and during the examination were reasonable and justified by the examination scope.	1	2	3	4	5
3. The examination team conducted the examination in a professional manner.	1	2	3	4	5
4. The examination placed appropriate reliance on the internal audit function and internal risk management functions in the institution to support effective supervision.	1	2	3	4	5
5. The examiner-in-charge and examination team were knowledgeable.	1	2	3	4	5
6. The examiner-in-charge and examination team provided useful feedback, observations and suggestions.	1	2	3	4	5
7. The examiner-in-charge and examination team presented well-supported relevant conclusions regarding the condition of the bank.	1	2	3	4	5
8. The recommendations for corrective actions made by the examiner-in-charge and the examination team were reasonable.	1	2	3	4	5
9. During exit and board meetings, the examiner-in-charge and examination team clearly and effectively communicated their findings and concerns.	1	2	3	4	5

	Completely Agree		Somewhat Agree		Completely Disagree
10. The tone and the content of the report of examination were consistent with the exit and board meetings.	1	2	3	4	5
11. The report of examination clearly communicated examination findings, significant issues and the corrective actions (including timeframes) management and/or the board needed to take.	1	2	3	4	5
12. On-going communication by the examiner-in-charge with senior management and the board of directors was appropriate.	1	2	3	4	5
13. Examiners minimized the burden to the degree possible on the bank, its officers and employees when conducting the examination.	1	2	3	4	5
14. The supervisory objectives and strategy incorporated appropriate perspective and provided necessary focus on business risks, assessment of their significance, and resulted in appropriate development of the examination strategy, emphasis on key risk areas and resulting areas of focus in the examination.	1	2	3	4	5
15. The examination report was delivered in a timely manner, so examination results and corrective actions required by bank management were influenced in a timely and appropriate manner.	1	2	3	4	5

Regarding the OCC's overall supervision of your institution:

16. During the past year or 18 months (i.e., the examination cycle), OCC _______ has/have been responsive to the bank's needs:					
a) field staff;	1	2	3	4	5
b) corporate staff (e.g., for corporate applications);	1	2	3	4	5
c) attorneys (e.g., for legal opinions);	1	2	3	4	5
d) accountants (e.g., for accounting opinions);	1	2	3	4	5
e) other ____________________________.	1	2	3	4	5
(Please do not respond to b, c, d, or e if you have not dealt with OCC's corporate staff, attorneys, accountants, etc.)					
17. The OCC identifies potential problems before they can cause significant harm to the bank.	1	2	3	4	5
18. The OCC's supervisory efforts focus on banking activities that pose the highest risk.	1	2	3	4	5
19. OCC regulations:					
a) effectively target the areas of bank activity that present the greatest risk to safety and soundness, the payments system, or the long-term viability of the national banking system;	1	2	3	4	5
b) promote national banks' competitiveness and allow industry innovation;	1	2	3	4	5

	Completely Agree		Somewhat Agree		Completely Disagree
c) eliminate unnecessary regulatory requirements and minimize the burden resulting from requirements necessary for effective supervision.	1	2	3	4	5
20. The OCC works with the bank and follows-up to ensure bank management addresses potential problems and risks.	1	2	3	4	5
21. The OCC allows the bank to offer new products and services if the bank has the expertise to manage the risks effectively and to provide the necessary consumer protections.	1	2	3	4	5
22. The OCC enforces CRA and fair lending laws by focusing on the bank's performance.	1	2	3	4	5

Please use the space below to add any descriptive comments or add additional pages, if needed.

What are the most useful aspects of the OCC's supervision, including the examination just completed?

What are the least useful aspects of the OCC's supervision, including the examination just completed?

Please indicate any areas where you think OCC examiners need greater knowledge to understand your bank's lines of business and their inherent risks.

Please address any areas where you think the OCC's fundamental supervision approach and/or methods of supervision need to change to evolve to keep pace with the industry.

Please return this form to: Samuel Golden, Ombudsman, 1301 McKinney Street, Suite 3725, Houston TX 77010. Phone (713) 336-4350 Fax: (713) 336-4351.

OFFICE OF THE OMBUDSMAN

Facilitating the National Appeals Process and Customer Assistance