Office of Inspector General

March 10, 2003
Audit Report No. 03-017

Material Loss Review of the Failure of the Connecticut Bank of Commerce, Stamford, Connecticut

MATERIAL LOSS REVIEW OF THE FAILURE OF THE CONNECTICUT BANK OF COMMERCE

TABLE OF CONTENTS

TABLES

FIGURE

DATE: March 10, 2003

MEMORANDUM TO: Michael J. Zamorski, Director
Division of Supervision and Consumer Protection

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of the Failure of the Connecticut Bank of Commerce, Stamford, Connecticut* (Audit Report No. 03-017)

In accordance with section 38(k) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1831o, the Office of Inspector General (OIG) conducted a review of the failure of the Connecticut Bank of Commerce (CBC), Stamford, Connecticut. On June 26, 2002, the Banking Commissioner of the State of Connecticut declared CBC insolvent, ordered it closed, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. At the time of failure, CBC reported total assets of approximately $379 million. As of December 31, 2002, the FDIC estimates that the failure of CBC may ultimately cost the Bank Insurance Fund (BIF) $63 million.

As mandated by the FDI Act, the audit objectives were to: (1) ascertain why the bank's problems resulted in a material loss[1] to the insurance fund and (2) assess the FDIC's supervision of the bank, including implementation of the Prompt Corrective Action (PCA)[2] requirements of section 38 of the FDI Act. In this report, we address each of these objectives and discuss our findings as part of our analysis of the bank's failure and the FDIC and State of Connecticut regulators' efforts to require CBC's management to operate the bank in a safe and sound manner. Appendix I contains additional information on our objectives, scope, and methodology.

BACKGROUND

CBC, formerly known as The Woodbridge Bank and Trust Company, was established in 1964 and renamed Amity Bank in 1978. During the 1970s and 1980s, Amity Bank emphasized commercial real estate lending. When the Connecticut economy, specifically the real estate sector, began

[1]A material loss is generally defined by section 38 of the FDI Act as a loss that exceeds $25 million and 2 percent of the institution's total assets at the time the FDIC was appointed receiver.
[2] See the glossary at the end of this report for an explanation of this and other terms and acronyms used throughout this report.

experiencing a severe downturn in the late 1980s, the bank suffered large operating losses and capital depletion. The FDIC imposed a Cease and Desist (C&D) order in July 1991, that required, among other things, increased capital, revisions to the loan policy, and a policy addressing the sufficiency of the loan loss reserve. In August 1992, with the bank on the verge of failure, a private investor recapitalized the bank and acquired over 80 percent ownership interest by purchasing common stock in exchange for $5 million in cash. The private investor also became the Chairman of the Board of Directors (Chairman) of the bank. On January 11, 1993, the bank's name was changed from Amity Bank to Connecticut Bank of Commerce.

After the acquisition, the bank continued to experience significant operating losses and capital depletion due to its deteriorating loan portfolio. The bank received a CAMELS[3] "5" rating, the worst level, at a September 1993 examination and was subsequently placed under a second C&D by the FDIC in December 1993 because of managerial weaknesses. During 1994, the bank continued to struggle financially, and the Chairman injected additional capital, almost $9 million, averting failure once again. At examinations performed in 1994, 1995, and April 1996, the bank continued to be rated a Composite "5." During that time the Chairman continued to inject capital into the bank as needed and by the end of 1996, his total capital investment in the bank was over $17 million, according to FDIC records. The bank was upgraded to a composite "4" rating at the December 1996 examination, in part, due to the additional capital from the Chairman. Apparent improvement in the bank's condition noted in the October 1998 examination resulted in an upgrade in the composite rating to a "3," the termination of the two outstanding C&D orders, and the adoption of an informal Memorandum of Understanding (MOU) between the bank, the FDIC, and the Banking Commissioner of the State of Connecticut. As part of the MOU, bank management agreed to, among other things, establish prudent lending limits, devise plans to reduce problem assets, maintain minimum capital levels, and notify the FDIC's Regional Director and the Connecticut Banking Commissioner of any new lines of business under consideration by the bank.

On April 23, 1999, just one month after termination of the C&D orders, the bank entered into a Purchase and Assumption agreement (subject to regulator approval) with MTB Bank, a New York state-chartered commercial bank with total assets of approximately $278 million. Under the terms of the agreement, CBC would purchase all of the traditional banking assets and assume all of the deposits and certain liabilities of MTB Bank for a purchase price of $20 million. MTB Bank was headquartered in New York City and specialized in lending to small and mid-sized businesses domestically and to companies abroad. According to the Purchase and Assumption application, MTB Bank had banking services that were complementary to CBC in accounts receivable and asset-based lending. The Purchase and Assumption application noted that "The melding of these complementary businesses into a single institution will result in a bank with the financial and managerial resources and capabilities to compete with the large regional and money center banks in these core banking lines of business."

Before the Purchase and Assumption transaction, MTB Bank was experiencing problems and was operating under an MOU entered into on September 16, 1998 with the FDIC. A November 1998 joint (FDIC and State of New York) examination report had rated the bank a CAMELS "3," and criticized the bank's risk management process, asset/liability management, and internal

[3] CAMELS (capital, asset quality, management, earnings, liquidity, and sensitivity to market risk) are factors assessed by regulators during examinations.

controls. A subsequent joint examination report dated November 1999[4] noted "the overall condition of the bank was satisfactory; however, management performance remains fair." The bank's condition had improved since the November 1998 examination, and it was upgraded to a CAMELS "2" rating, although its management component rating remained a "3." The report also noted that "[t]he assessment of management reflects the increase in asset classifications, weaknesses in credit administration, audit, and funds transfer…Weaknesses in audit include lack of a written risk assessment for areas that are audited and not completing the annual audit plan." The 1999 report also noted that adversely classified assets as a percentage of Tier 1 Capital and loan loss reserves increased from 10.4 percent in September 1998 to 27.7 percent in September 1999. Examiners were concerned that "although the level is generally considered manageable, the overall trend in volume and severity warrants a moderate level of concern." At a meeting with officials from CBC and MTB Bank in May 1999, Division of Supervision and Consumer Protection[5] (DSC) officials in the Boston Regional Office explained that it would be difficult to approve the Purchase and Assumption of two "troubled banks;" however, that would not preclude CBC from submitting an application. On August 4, 1999, CBC filed an application with the FDIC and the State of Connecticut Department of Banking to acquire MTB Bank. According to the application, the Chairman had agreed to enter into a subscription agreement with CBC whereby he would purchase $10 million of common stock and $10 million of preferred stock, the proceeds of which would be used to consummate the sale agreement. As shown in Table 1, MTB Bank had almost three times the assets of CBC.

Table 1
Comparison of CBC and MTB Information
as of December 31, 1999
($ in thousands)

	CBC	MTB
Assets	$99,521	$277,867
Loans	$72,990	$131,295
Deposits	$90,649	$222,373
Equity Capital	$8,172	$28,156
Enforcement Actions	MOU	MOU
Composite Rating Component Ratings	3 2-3-3-3-2-2	2 2-2-3-2-2-2

Source: Call Reports

[4] According to DSC officials, this report was completed but never issued to the bank because CBC's proposed acquisition of MTB Bank had already been approved and therefore MTB Bank was about to go out of existence.
[5] Effective July 1, 2002, the FDIC's Division of Supervision and Division of Compliance and Consumer Affairs were merged to form the new Division of Supervision and Consumer Protection (DSC). The DSC promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions.

Before approving CBC's application to acquire MTB Bank, the FDIC and the State of Connecticut conducted a joint examination of CBC beginning in December 1999. That examination showed continued improvements in capital and asset quality; however, the composite rating remained a "3" and the MOU remained in place. Because of the improvement in the condition of the bank and the Chairman's perceived financial strength, the FDIC and the Connecticut Banking Commissioner approved CBC's application to purchase MTB Bank in February 2000. On March 31, 2000, the bank acquired substantially all of the assets and assumed all of the deposits and certain liabilities pertaining to the banking operations of MTB Bank. The transaction specifically excluded the acquisition of assets and assumption of liabilities relating to MTB's precious metals business. CBC acquired net assets of $20,989,000 that consisted of $247,389,000 in assets, $214,200,000 in deposits, and $12,200,000 in other liabilities. The purchase price was $20 million, which represented a $989,000 discount from book value. In connection with the transaction, the Chairman of the Board of Directors of CBC purchased $10 million of CBC common stock, and a company he controlled purchased $10 million of CBC preferred stock. The proceeds from the issuance of the common and preferred stock were used by CBC to fulfill its contractual obligations under the Purchase and Assumption agreement with MTB Bank.

Regulators performed a limited on-site "visitation" (limited-scope examination) at the bank during September 2000, after the acquisition of MTB Bank. During an examination in March 2001, FDIC and State of Connecticut examiners became suspicious of an unusually high volume of loan activity that had occurred at the bank in March 2000. After they began investigating the matter, they discovered that over $20 million of loans funded in the latter part of March 2000 were ultimately channeled to the bank's Chairman and used to fund the acquisition of MTB Bank. The irregularities surrounding these loans coupled with other asset quality problems led to the bank's closure on June 26, 2002, less than 27 months after it acquired MTB Bank.

On November 22, 2002, the FDIC issued a Notice of Charges seeking to impose civil money penalties (CMPs) totaling $5.25 million against a group of former officers and directors of CBC. The Notice of Charges, among other things, alleges that the Chairman of the Board and the bank president orchestrated certain nominee[6] loan schemes, the proceeds of which were used to make the capital injection through the purchase of common and preferred stock into CBC that ultimately paid for the acquisition of MTB Bank; refinance nonperforming loans in a nominee borrower's name; keep nominee loans current or pay them off; and improperly provide funds to the Chairman and related entities. According to the Notice of Charges, the bank's directors approved most of the nominee loans and failed to fulfill their fiduciary responsibilities to CBC. The FDIC viewed the nominee loan scheme as having had the effect of misleading bank regulators and CBC depositors as to the true financial condition of CBC, ultimately leading to CBC's closure.

[6] According to the Department of Justice Criminal Resource Manual, a third-party or "nominee" loan is a loan in the name of one party that is intended for use by another. A misapplication occurs when a financial institution insider uses his position to secure a nominee loan, either for himself or for another person, and the insider conceals his own interest in the loan from the financial institution.

In addition to the CMPs, the FDIC is seeking Orders prohibiting the Chairman and president from further participation in the banking industry and requiring restitution in the amount of $34 million. The Connecticut Department of Banking is also pursuing CMPs against the same parties.

RESULTS OF AUDIT

The CBC failed and resulted in a material loss to the Bank Insurance Fund because of ineffective corporate governance. The Board of Directors and senior bank management:

- Disregarded sound underwriting practices by making highly speculative and insider loans;
- Used complex transactions and questionable asset valuations to mask the true financial condition of CBC;
- Circumvented or disregarded various laws and banking regulations related to safety and soundness;
- Failed to ensure that the bank's internal audit function was independent, effective, and complied with applicable regulations; and
- Ignored or did not fully implement examiner recommendations and enforcement actions.

Additionally, CBC's external auditors issued unqualified or "clean" opinions on the bank's financial statements that briefly described but did not challenge the presentation of certain questionable transactions and asset valuations. External auditors rendered unqualified opinions on CBC's financial statements every year from 1996 through 2001. However, the auditors did not always follow up on questionable asset valuations reported in CBC's financial statements and Call Reports to regulators that represented a significant portion of CBC's capital. As a result, CBC's capital was overstated every year in its financial statements and regulatory Call Reports from at least 1997 until the bank failed.

The Chairman of the Board orchestrated loan schemes that were key to the material loss to the Bank Insurance Fund. A major component of the estimated $63 million loss to the insurance fund resulted from the Chairman of the Board orchestrating a scheme where the bank made $20 million in nominee loans to various companies controlled by the Chairman, his family members, and associates in order to fund the acquisition of MTB Bank. The Chairman later devised other loan schemes involving poorly underwritten loans that were used to make payments on the nominee loans and to pay off other non-performing loans. The FDIC estimates that the $34 million in outstanding balances of loans originated as part of these schemes have little monetary value.

With respect to the supervision of CBC, FDIC and state examiners conducted annual examinations, consistently identifying and reporting deficiencies, and taking various formal and informal enforcement actions. In 2001, examiners discovered unusual loan activity at the bank and promptly began an investigation that eventually uncovered the nominee loan

schemes. However, in retrospect, more aggressive supervisory action and additional scrutiny of CBC's application to purchase MTB Bank was warranted in light of CBC's:

- **risky lending and weak management practices,**
- **failure to fully resolve examination findings and comply with enforcement actions, and**
- **questionable "satisfactory" CRA rating when the application was pending approval.**

FDIC and state examiners conducted annual examinations and/or targeted examinations of CBC from 1993 until its closure. The examiners repeatedly identified and reported on significant, yet uncorrected, problems at the bank in resulting examination reports. Examiners also required the bank to operate under two C&D Orders from 1993 to 1999, an MOU from 1999 until 2001, and another C&D Order from December 2001 until CBC failed. In February 2000, the FDIC approved CBC's application to purchase MTB Bank notwithstanding CBC's long history of uncorrected management deficiencies identified in examination findings and enforcement actions and absent validation of the Chairman's source of funds for acquiring MTB Bank. Finally, the 1999 Community Reinvestment Act performance evaluation for CBC did not reflect the bank's actual performance, rather the evaluation was largely based on future projections of the bank's performance and the bank's performance in the context of factors not clearly applicable to the institution. As a result, the rating may not have been an appropriate one on which to base approval of the bank's application to acquire MTB Bank.

Finally, the FDIC implemented PCA in accordance with the requirements of section 38 of the FDI Act; however, PCA was not fully effective due to improper asset valuations that overstated CBC's capital for several years. Because CBC masked the true nature of certain financial transactions, examiners did not determine the actual financial condition of CBC until a full investigation was performed subsequent to the March 2001 examination. Once the loan schemes were uncovered, the examiners concluded that bank was critically undercapitalized. As a result, enforcement actions, including those available under PCA, were not fully effective at minimizing the loss to the insurance fund.

This report contains five recommendations designed to help improve the bank supervision process and to promote the safety and soundness of FDIC-regulated institutions.

FINDINGS AND RECOMMENDATIONS

WHY THE BANK'S PROBLEMS RESULTED IN A MATERIAL LOSS

Corporate Governance

The bank's Board of Directors[7] (or Board) and senior management exhibited a pattern of mismanagement of the bank and failed to provide an adequate system of corporate governance.[8] The Board of Directors' lack of adequate oversight was a principal cause of the bank's failure, and happened in large part because the Chairman dominated the bank's Board. Mismanagement of the bank included failing to diversify the risk of the bank's loan portfolio, engaging in high-risk activities without proper risk management processes, circumventing or disregarding various laws and banking regulations, and frequently ignoring examiner recommendations. Adding to these problems were a weak internal audit function and external audits that did not always follow up on certain questionable asset valuations that were material to CBC's financial statements. To achieve an effective corporate governance environment, all four areas – the Board, senior management, internal audit, and external audit –must be in place and working cohesively. As discussed below, this did not occur at CBC.

Board of Directors

The Board failed to establish an adequate control environment at CBC and to implement corrective actions that examiners recommended. The FDIC and state examination reports from 1996 through 2001 cited CBC's Board and management for ignoring recommendations regarding asset quality, credit administration, and risk management. Also, minutes of both the Board and Board Credit Committee meetings did not detail discussions of the views expressed by each member in attendance on any item or the record of any vote, even when loans presented for approval lacked sufficient documentation, were contrary to lending policies, or were affiliated with the Chairman of the Board. Board minutes indicated that Board members did not actively question or request details on assets, credit administration, and risks. Because the Board did not adequately perform its duties, CBC operated in an unsafe and unsound manner that eventually led to its collapse.

According to the DSC's *Manual of Examination Policies*, the quality of management is probably the single most important element in the successful operation of a bank. "Management" includes both the Directors on the Board, who are elected by the shareholders, and the executive officers, who are appointed to their positions by the Board.

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[7] The FDIC and state examination reports for 1996 through 2002 listed as few as five and as many as eight directors including the Chairman at CBC. The examinations also noted that the directors other than the Chairman were independent of the bank.

[8] The Institute of Internal Auditors identifies the board of directors, senior management, internal auditors, and external auditors as the cornerstones of the foundation on which effective corporate governance must be built (see Institute of Internal Auditors "Recommendations for Improving Corporate Governance." Position paper to the Special Committee of the Board of Directors of the New York Stock Exchange, March 28, 2002).

Examiner guidance contained in DSC Examination Modules addresses various control and performance standards in evaluating a bank's management. These standards include whether the bank's Board has established policies to maintain a system that effectively measures and monitors risk and to implement corrective actions recommended by auditors and supervisory authorities. To determine whether a bank's risks are adequately identified, measured, monitored, and controlled, the examiners evaluate whether the Board has:

- Identified and assessed major risks that influence the success or failure of the bank,
- Established adequate policies and procedures given the size and complexity of the bank,
- Implemented adequate controls to ensure adherence to bank policies as well as legal and regulatory requirements, and
- Implemented appropriate systems to monitor the bank's activities.

The Board's failure to provide adequate oversight of the bank resulted in concentrations of credit risk, high-risk lending, and a disregard for banking laws and regulations and for examiner recommendations. (Each area is discussed in detail later in this report.) FDIC and State of Connecticut examination reports from 1996 through 2001 identified numerous matters requiring Board attention pertaining to the lending function. These areas included basic tenets of banking such as risk management, asset quality, loan policies, and loan administration. For example, the 1997 examination report disclosed that the bank had entered into a new lending area, accounts receivable purchases, "without a formal or informal [loan] policy, or procedure guidelines." As of October 1997, without any requisite policies or procedures, the bank's lending in accounts receivable purchases had grown to $21.6 million and equaled 259 percent of Tier 1 Capital and reserves.[9] Moreover, examiners found these loans to be "riddled with documentation and administrative deficiencies, including the lack of financial information on the individual obligors." Subsequent examination reports show that CBC's Board of Directors did not adequately address these matters. Further, the Board did not address the fact that typically 45 percent of CBC's loans were to borrowers outside the state of Connecticut, including borrowers in Central and South America and Canada. The bank did not demonstrate the expertise to monitor these international loans.

Also, with respect to the Board of Directors, examiners repeatedly criticized bank management regarding the lack of detail contained in the minutes of Board of Directors' meetings. These minutes did not adequately document management's activities or reflect discussion and the decision-making process. Board minutes were devoid of pertinent details regarding discussions and information about the bank's activities. These deficiencies existed even though the bank had been under a Cease and Desist order that required detailed written minutes of all Board meetings to be maintained and recorded on a timely basis.

Section 4.1 of DSC's *Manual of Examination Policies* discusses the importance of detailed Board minutes. "A director's attendance should be an informed and intelligent one, and the record

[9] Regulators often use a percentage of Tier 1 Capital to identify possible absence of risk diversification within an institution. At the FDIC, the percentage of Tier 1 Capital used to identify potential absence of risk diversification is 25 percent or more for loans to individuals and 100 percent or more for loans by industry or product line.

should show it. If directors dissent from the majority, they should, for their own protection, insist upon their negative vote being recorded along with the reasons for their action. …Results of board deliberations on any matter involving a potential conflict of interest should be noted clearly in the minutes."

FDIC and state examination reports from 1997 through 2001 consistently recommended that Board minutes include details as to discussion items and the concerns any director expressed. For example, examiners wrote in the October 1998 exam, "minutes lack sufficient detail as to discussions. There were no specifics as to who had concerns and what they were. It is again recommended [referring to the September 1997 examination report] that the Board minutes be enhanced to include more details as to discussions on all areas of importance." In the FDIC Report of Examination of March 2001, the examiners cited CBC's Board minutes as not timely and noted that they "did not adequately reflect the substance or content of Board concerns or oversight actions."

We also noted problems in recording the Board's Credit Committee minutes. At the April 2002 examination, examiners noted, "Reasons for voting against a credit, or for abstaining, recusing, or exiting the room were not always explained or identified in the minutes... In most cases, substantive and lengthy discussions regarding the credit proposals were not sufficiently detailed." The examiners also stated that minutes should document related interests, affiliates, business associations, interrelated borrowing relationships, and potential conflicts of interest.

An egregious example of Board deficiencies was evidenced by the March 2000 Board meeting where loans totaling over $20 million were approved by the Board, well above the typical monthly volume and very substantial in relation to the size of the bank. Most of the loans approved at this meeting lacked adequate financial analysis and contained inaccurate or incomplete information about the borrowers. Further, information about the purpose of the loans was vague, typically describing the purpose as working capital or investments. Also, many of the loans were in contravention of CBC's loan policy (lacked personal guarantees) and safe and sound banking practice due to their weak underwriting. Nevertheless, it appears none of the directors questioned any of these loans or probed deep enough to learn the details or offer any objections. Examiners later discovered that the proceeds from these loans were used by the Chairman to fund the acquisition of MTB Bank through his purchase of CBC common and preferred stock with the proceeds.

Senior Management

Senior management[10] also did not fulfill its responsibilities to operate the bank in a safe and sound manner, in part, because the Chairman dominated them. Specifically, senior management continually engaged in hazardous lending, did not ensure proper loan administration procedures, and did not provide a sufficient Allowance for Loan and Lease Losses (ALLL). These failures of the bank's senior management contributed to the collapse of CBC.

[10] Senior management refers to executive officers and excludes directors.

According to Section 4.1 of DSC's *Manual of Examination Policies*, the primary responsibility of executive management is implementation of the Board's policies and objectives in the bank's day-to-day operations. A bank's performance with respect to asset quality and diversification, capital adequacy, earnings capacity and trends, and liquidity and funds management is, to a very significant extent, a result of decisions made by the bank's directors and officers. When significant problems exist in a bank's overall condition, consideration must be given to management's degree of responsibility. At a minimum, the assessment of management by bank examiners should include the following considerations:

1. Whether or not insider abuse is in evidence;
2. Existing management's past record of performance in guiding the bank;
3. Whether loan losses and other weaknesses are recognized in a timely manner;
4. Past compliance with supervisory agreements, commitments, orders, etc.; and
5. Capability of management to develop and implement acceptable plans for problem resolution.

According to FDIC and state examination reports from 1996 through 2001, senior management did not comply with existing policies regarding insider transactions, continually violated laws and regulations, and disregarded some of the regulators' concerns. Senior management's failure to address these concerns led to an increase in the volume of adversely classified loans. Numerous loans, including insider loans, contained severe underwriting, credit, and collateral deficiencies. Some of the problems identified by examiners included:

- Underwriting decisions made based on stale, incomplete, or nonexistent financial statements.
- High reliance placed on borrower-provided financial projections, some of which had never been achieved.
- Audited or reviewed financial statements not obtained despite Credit Policy requirements.
- Personal guarantees not obtained.
- Lack of an analysis and/or appraisal of collateral securing loans.
- Assignment of leases not obtained.
- Ownership not well documented in the credit files.
- Updated personal and corporate financial statements and tax returns not regularly obtained as required. For those obtained, the tax returns or personal financial statements were not signed or did not include supporting schedules (lack of statement of cash flow and footnotes).
- Over advances on factoring lines, accounts receivable purchase facilities, or inventory lines allowed without appropriate control or monitoring.
- Violations of laws and regulations pertaining to insider lending and affiliate transactions.

Management also failed to adequately identify and recognize credit risk associated with loans, leases, and other commitments for the ALLL. According to the FDIC 2002 draft Examination Summary Report,[11] "the integrity of the ALLL calculation is heavily predicated upon the accuracy of the internal loan grading system. The examination revealed significant discrepancies between internal loan risk ratings and examiner-assigned classifications. Of the

[11] The 2002 FDIC draft Examination Summary Report was never processed or issued due to the bank's failure before the examination was completed.

$98 million in loans adversely classified at this examination, approximately 40% were not internally criticized by management. These inaccuracies resulted in the underfunded ALLL as of March 31, 2002." Many of these loans originated in prior periods.

Finally, examiners expressed concerns over the Chairman's apparent domination and control of the bank starting in the FDIC Report of Examination as of December 1996. That report stated "The management of the institution is dominated and controlled by the principal shareholder and Chairman of the Board." The report further noted concerns regarding risk tolerance; the underwriting, approval, monitoring, and collecting of loans to entities that have an affiliation to the Chairman and/or one of his related interests; and the appropriate role for a principal shareholder in the day-to-day operation of the institution.

Internal Audit

CBC's internal audit function was inadequate. According to FDIC and state examination reports from 1997 through 2001, the internal audit function lacked independence and effectiveness, and did not comply with regulations. A strong internal audit function helps to ensure that proper internal controls, policies, and procedures are continuously practiced.

According to Section 4.2 of the DSC *Manual of Examination Policies*, a strong internal auditing function establishes the proper control environment and promotes accuracy and efficiency in the bank's operations. The basic purpose of internal auditing is the safeguarding of assets and the prevention and detection of problems before they result in losses. The auditor's role is to help safeguard the bank's assets by performing tests and procedures establishing the validity and reliability of operating systems, procedural controls, and resulting records. Auditors must have complete independence in carrying out the audit program and should report their findings directly to the bank's board of directors or a designated directors' audit committee.

<u>CBC's internal auditors lacked independence:</u> In July 1996, CBC contracted the internal audit function to its external auditors. According to the FDIC's October 1997 examination report, the external auditor's independence was impaired because the same audit team conducted both the external and internal audits. In 1998, the FDIC considered independence between the internal and external auditing functions restored because separate audit teams within the same firm were performing the audits.[12]

According to documentation we reviewed in CBC's files and the March 2001 examination report, CBC in 1998 appointed an employee who was serving as the Risk Manager as internal auditor. As an auditor, he audited areas for which he had a role or responsibility in approving procedures or making management decisions as the risk manager. Again, FDIC examiners noted the internal audit function lacked independence.

[12] Although not if effect at the time, the Sarbanes-Oxley Act of 2002, Title II--Auditor Independence, Section 201 (g) prohibits a public accounting firm that performs for any issuer any audit to also provide internal audit outsourcing services to that issuer.

The internal audit function was not effective: The internal audit function was not effective because it delayed in addressing external audit findings and correcting internal control weaknesses, took excessive time to develop an internal audit structure, and formulated inadequate audit plans.

- According to the March 2001 examination report, several stale and repeat internal audit report findings dating back to July 1999 had not been resolved because CBC's Risk Management Policy did not assign responsibility for managing and monitoring risk.

- The examiner's evaluation of CBC's internal audit function in March 2001 noted several deficiencies in the audit risk assessment process, audit report process, and the audit manual.

- The October 1998 FDIC examination report stated that the scope and coverage of the audit plan were inadequate because the scope missed critical internal control checks on insider transactions, Regulation O compliance, and compliance with the CBC Conflicts of Interest Policy.

- According to DSC's April 2002 draft Examination Summary Report, "internal audit work completed since the previous examination does not adequately address examination criticisms with respect to commercial lending, as well as insider and affiliate relationships."

The internal audit function did not comply with regulations: According to the FDIC October 1997 examination report, CBC was not complying with 12 C.F.R. Part 364, App.A, § IIB, regarding minimum standards for an internal audit program. These standards require, among other things, adequate monitoring of the institution's internal control system and verification and review of management's actions to address material weaknesses. CBC had also violated 12 C.F.R. section 326.8(c)(2) regulations for establishing an internal audit program to ascertain compliance with the Bank Secrecy Act (BSA), which requires banks to report each cash transaction that exceeds $10,000 in one day.

CBC's oversight of the internal audit function did not adequately ensure that management continuously implemented and practiced sound internal controls, policies, and procedures. The FDIC and state examination reports from 1997 through 2001 cited several significant internal audit program deficiencies that required the attention and corrective action of the Audit Committee and the Board. However, the Board's oversight of the internal auditing function, through the Audit Committee, failed to establish the proper control environment, or to promote accuracy and efficiency in the bank's operations. This was a contributing factor to CBC's collapse.

External Audit

External auditors rendered unqualified opinions on CBC's financial statements every year from 1996 through 2001. However, we found that the external auditors did not always follow up on questionable asset valuations. For example, questionable valuations regarding CBC's interest in four cargo planes were not adequately addressed in financial statements from 1997 until CBC failed. As a result, CBC's capital was overstated every year in its financial statements and regulatory Call Reports from at least 1997 until CBC failed. The differences in asset valuations led to inaccurate financial reporting to CBC's stockholders and to the public.

The *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations* states that accurate financial reporting is essential to an institution's safety and soundness for numerous reasons. First, accurate financial information enables management to effectively manage the institution's risks and make sound business decisions. Management provides data to stockholders, depositors and other funds providers, borrowers, and potential investors on the company's financial position and results of operations. Such information is critical to effective market discipline of the institution.[13]

We reviewed the external auditors' workpapers for the financial statement audits for 2000 and 2001.[14] The workpapers contained evidence that the external auditors questioned management about certain asset valuations and supporting documentation, especially for those loans pertaining to the Chairman and his associates. However, the workpapers did not indicate whether or not bank management provided an adequate response to the questions. Also, the external auditors did not adequately address the valuation of cargo planes carried on CBC's books from 1997 until it failed. Based on our review of the external auditors' workpapers, they questioned certain asset valuations, yet according to their workpapers, they did not pursue the matters to closure. For example, during the 2000 and 2001 audits, auditors raised a number of questions to bank management about their ownership interest in, and valuation of, four cargo planes. (The bank's interest in these cargo planes is further discussed in the "Following Up on Red Flags" section of this report.) File documentation at the bank was lacking and the terms of this transaction were vague. CBC's ownership interest in these planes was unclear, as apparently no perfected lien was on file. No onsite appraisal had been performed and the bank obtained only "desktop" appraisals for these planes. As a result, critical information such as the condition of the planes, engine age, flight hours, and maintenance records was not considered in the planes' valuation. Because these planes represented 68 percent of the bank's equity capital in 1997, external auditors should have pursued this matter further. DRR officials informed us that these planes were apparently sold in 2001, and the bank received nothing from the sale. The external auditors did not discover this sale during their year-end 2001 audit.

The bank valued these planes from $4 million to $5.2 million from 1997 until CBC failed in June 2002. From 1997 through 2001, external auditors attested to the accuracy of the valuation of the planes. However, the bank's financial statements did not fairly present the financial condition of CBC, and regulatory Call Reports were not accurate due to these and other valuations being overstated. These unreliable financial reports misrepresented CBC's financial position to regulators, depositors, shareholders and the public.

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[13] *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations*, The Federal Financial Institutions Examination Council, September 1999, page 1.

[14] The bank's external auditor for the 2000 and 2001 financial statement audit was Arthur Andersen, LLP. Prior to 2000 it was BDO Seidman, LLP.

Failure to Diversify the Risk of the Bank's Loan Portfolio

Analysis of CBC's loan portfolio from 1996 until it failed in 2002 indicates that management did not give adequate attention to diversifying risk and, as a result, concentrations of credit risk occurred in its loan portfolio. The failure to diversify risk, coupled with poor underwriting and poor loan administration, contributed to the material loss that resulted from the failure of CBC.

Greater regulatory attention is required when asset concentrations exceed 25 percent of Tier 1 Capital. According to section 3.1 of the DSC *Manual of Examination Policies*, concentrations are a significantly large volume of economically related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. Adequate diversification allows the institution to avoid the excessive risks imposed by credit concentrations. It should also be recognized, however, that factors such as the location of the institution and the economic environment of its lending area can limit an institution's ability to diversify. Where reasonable diversification cannot be achieved, the resultant concentration calls for capital levels higher than the regulatory minimums.

The DSC *Manual of Examination Policies* further states that concentrations generally are not inherently bad but do add a dimension of risk, which the management of the institution should consider when formulating plans and policies. In formulating these policies, management should, at a minimum, address goals for the institution's portfolio mix and set limits within the loan and other asset categories. All concentrations should be monitored closely by management and receive a more in-depth review than the diversified portions of the institution's assets. Recognizing that concentrations may indicate an absence of risk diversification within the institution's asset structure, the DSC *Manual of Examination Policies* requires examiners to detail in the report concentrations aggregating 25 percent or more of Tier 1 Capital by:

- individual borrower;
- small, interrelated group of individuals;
- single repayment source with normal credit risk or greater; and
- individual project.

A review of FDIC and State of Connecticut examination reports from 1996 through 2001 revealed the following:

- The December 30, 1996 FDIC examination report criticized the bank "for having a significant concentration of credit, 253.5% of Tier 1 capital" with one borrower. The $13 million in loans to this one borrower represented over 21 percent of the loan portfolio as of the examination date. Noting that risk diversification is a tenet of sound banking, the examiner stated that the Board needed to review this relationship and establish prudent limits.

- In the October 20, 1997 FDIC examination report, concentrations of credit were identified again and examiners recommended that the bank's directors review the concentrations and adopt a diversification policy. Also, the examiners noted these concentrations posed additional types of risk. Three concentrations of credit totaling $27.3 million were identified, which represented 433 percent of Tier 1 Capital and over 45 percent of the book value of the bank's loan portfolio.

- The October 26, 1998 State of Connecticut examination report noted "Risk diversification remains a concern as five relationships ranging from 30% to 138% of Tier 1 Capital are listed in the Concentrations page. The level of concentrations [has] increased from three cited at the prior examination." The report further noted that "Given the weaknesses identified in these relationships as well as the increasing number of overall concentrations, the need for appropriate guidelines and adequate staffing becomes increasingly important. At a minimum, policies should address goals for portfolio mix and limits within the loan and other asset categories."

- The December 27, 1999 examination report, jointly prepared by the FDIC and State of Connecticut, noted "Eight relationships, which in the aggregate, represent 491% of Tier 1 Capital are listed…within this report." The report further noted " The number of concentrations has increased from the five noted at the last examination."

- The March 5, 2001 examination report jointly prepared by the FDIC and State of Connecticut states: "Management is again reminded that risk diversification is a basic tenet of sound banking. Seven groupings of loan/asset concentrations, each representing greater than 25% of Tier 1 Capital are detailed on the concentrations page. Of concern is that the majority of these credits are adversely classified or contain loan administration deficiencies. Given these increased risk factors, it is imperative that management monitors these credits closely."

Despite numerous warnings by FDIC and State of Connecticut examiners, CBC's management repeatedly failed to diversify the risk of the bank's loan portfolio. Of particular concern was the number of loans to one borrower that exceeded 100 percent of Tier 1 Capital. From 1996 though to 2001, examiners identified at least three separate instances where loans to one borrower exceeded over 100 percent of Tier 1 Capital. Moreover, all of these concentrations contained underwriting and/or other credit deficiencies. Through this concentration of risk, CBC had positioned itself to possibly fail if just one of these loans had to be charged off. Based on our review of DRR loan sales and discussions with DRR account officers, the FDIC, as receiver, will likely realize significantly less than book value when these loans are eventually sold.

The Bank Engaged in High-Risk Activities Without Proper Risk Management Processes

A review of examination reports and related records shows that the bank had a history of engaging in high-risk activities without proper risk management policies and procedures in place. Also, the bank routinely engaged in out-of-territory lending. In 1999, more than 45 percent of CBC's loan portfolio involved companies operating outside of the State of Connecticut and sometimes outside of the United States. According to examiners, some of the lending by the bank appeared to be more representative of lending by venture capital companies as opposed to an FDIC-insured bank. This type of lending without a proper risk identification system is a direct result of the bank's directors and management failing to fulfill their responsibilities to run the bank in a safe and sound manner.

In guidance to examiners, the DSC Examination Documentation Modules state that Boards of Directors should establish adequate lending policies, procedures, and operating strategies. Inadequate lending policies and procedures may expose banks to greater risk. Bank management should conduct risk assessments to identify key business risks and should adhere to reasonable risk-taking practices.

CBC's Chairman directed the bank to engage in risky out-of-area lending without the benefit of proper guidelines or documented support for the transactions. Aggressive and uncontrolled risk-taking by the bank led to an increase in the bank's exposure to risk. Our review of examination reports indicates that the bank continually assumed high levels of risk in its loan portfolio without adequate processes to identify, measure, monitor, and control these risks. The December 1996 FDIC examination report noted that much of the bank's new commercial lending was in leases or purchases of receivables, and was out of state. Examiners were concerned that this type of lending requires "special technical expertise, close monitoring, and hands-on management." The report also indicated that the bank was already understaffed in its commercial loan department. Also, the examination report noted that the loan review process was almost nonexistent, documentation required as part of loan agreements was not being received or requested, and financial information to monitor credits was not being obtained.

Subsequent examination reports noted similar deficiencies. The 1999 examination report found that more than 45 percent of the bank's loan portfolio was made to companies doing business outside the state of Connecticut, including in Central and South America and Canada. The bank did not have policies in place for controlling risk in foreign countries. Also, the examination report identified that the bank was modifying and restructuring loans without current financial information. The 2001 examination report, under Matters Requiring Board Attention, noted that "risk management practices are severely deficient relative to the institution's size, complexity, and risk profile." The report further noted that "Sound underwriting standards need to be adopted and enforced." Based on examination reports, loan underwriting improved prior to, and deteriorated soon after, the acquisition of MTB Bank.

Weaknesses in risk management were exacerbated after the Purchase and Assumption of MTB Bank. With over $214 million of additional deposits acquired from MTB Bank, CBC funded tens of millions of dollars in high-risk lending and speculative ventures dealing with accounts receivable purchase financing, coal mining and oil exploration, and casino gambling. Many of these loans were to borrowers out of state and/or out of the country.

To illustrate:

- In November 2000, CBC lent money to a start-up company that operated a gaming facility, sports bar, and racetrack in Panama. The company was seeking to expand gambling operations in Central and South America. The original loan of $250,000 was amended 11 times, and by April 2002, the loan amount was in excess of $2.6 million. In addition, the company received a second loan from CBC in December 2001 for over $1.1 million. The purpose of this loan was related to the acquisition of slot machines for the gambling operations. Both loans were based on projected earnings of $23 million and $24 million for years 2001 and 2002 respectively, even though the company had lost over $300,000 in both 1999 and 2000. The guarantor for these loans was also experiencing net losses and collateral coverage was lacking. Repayment was solely dependent on the successful operation of an unproven company engaged in gambling operations in foreign countries. When the loans related to the gambling operation were sold by DRR, the total outstanding book value was over $5 million. Due to the poor underwriting and lack of collateral coverage, these loans were sold at an FDIC auction for less than $668,000, approximately 13 percent of their book value.

Prior to the acquisition of MTB Bank, CBC purchased $1.7 million in foreign currency options without fully understanding the risks assumed. The 1999 examination report stated that the volatility of these instruments made them more difficult to value than other more traditional investments. The uncertainty underlying these investments made them riskier than many other types of securities. Sound risk management principles would require risk management systems in place to evaluate the possible impact to earnings from adverse changes in market conditions. Such risk management systems were not in place at CBC.

Circumventing and Disregarding Banking Laws and Regulations

The bank was cited a number of times for apparent violations of banking laws and regulations at examinations performed from 1996 through 2001. The most significant one that contributed to the bank's failure and material loss pertained to legal lending limits of the State of Connecticut. CBC had several relationships on its books that appeared to violate legal lending limits.

CBC circumvented Connecticut statutes pertaining to legal lending limits to one borrower by concentrating a portion of its loan portfolio in accounts receivable purchase agreements. Legal lending limits are a means to diversify risk by limiting the dollar amount of loans to individual borrowers. However, CBC interpreted Connecticut banking law pertaining to liabilities to one obligor in a manner that permitted the financing of poor quality accounts receivable of a single obligor. Below we discuss how the bank was able to lend money oftentimes far in excess of its legal lending limit.

Legal lending limits help to protect the safety and soundness of banks by preventing excessive loans to one person, or to related persons that are financially dependent, and help to promote diversification of risk. As a state-chartered bank, CBC was subject to legal lending limits under Connecticut General Statutes Sec. 36a-262, which provides the following:

> Except as otherwise provided in this section, the total direct or indirect liabilities of any one obligor that are not fully secured, however incurred, to any Connecticut bank, exclusive of such bank's investment in the investment securities of such obligor, shall not exceed at the time incurred fifteen per cent of the equity capital and reserves for loan and lease losses of such bank.

Based on Call Report information, CBC's approximate legal lending limit (15 percent of equity capital plus the loan loss reserve) for the years 1996 through 2002 would have been as follows:

Table 2
CBC's Approximate Legal Lending Limit
1997-2002
($ in thousands)

Year	Lending Limit
1997	$1,241
1998	$1,366
1999	$1,529
2000	$5,810
2001	$6,099
2002	$6,601

Source: OIG analysis of Call Reports

Starting in 1997, the bank made a number of loans that appeared to exceed the legal lending limits of the State of Connecticut. The bank lent millions of dollars for what it termed "accounts receivable purchase facilities." The bank asserted that the accounts receivable purchase facilities were not loans but rather the outright purchase of the borrower's accounts receivable. By structuring the deals as purchases, the bank contended that each underlying account receivable was the de facto borrower and thus only the individual account receivable amount would be covered by the legal lending limits of the State of Connecticut. From 1997 through 1999, when its legal lending limit would have been somewhere between $1.24 million and $1.53 million, the bank lent money to several borrowers for accounts receivable purchases in excess of that amount, ranging as high as $10 million to one borrower.

We reviewed records that indicated the bank was of the view that the purchase of receivables was not subject to the limitations contained in section 36a-262 based on a number of factors including "the documentation and corporate approvals evidence the parties intent, to engage in a sale of the eligible receivables from the Seller to the Purchaser and not a financing secured by the receivables."

Examiners reviewing these transactions determined that these transactions were in-substance direct loans to the companies rather than accounts receivable purchases. This was based on a number of factors identified by examiners. Particularly, examiners noted that the initial accounts receivable as well as monthly individual accounts receivable were not in the bank's files; therefore, the obligors were not known. Also, there were no documented on-site reviews of the obligors, or documented reviews of the obligors' creditworthiness by the bank.

By December 31, 1999, accounts receivable purchases represented approximately 28 percent of the bank's total loan and lease portfolio. Several of these transactions were in excess of the bank's legal lending limit. According to DRR officials, one of these transactions with a book value over $6.5 million was sold in October 2002 for approximately $1.75 million, less than 27 percent of its book value.

Another way the bank was able to take advantage of legal lending limits was due to an apparent loophole in Connecticut banking law pertaining to legal lending limits. Relevant language in the Connecticut law provides limits on "the total direct or indirect liabilities of any one obligor." According to the FDIC and Connecticut banking officials we interviewed, as long as loans are made to separate legal entities and neither guarantees the obligation of the other, there would be no violation even though the companies could be interlocked and be using the proceeds for a common enterprise.

An example we noted at CBC occurred during 2001 and 2002, when CBC lent money to four different entities related to a coal-mining venture in Montana. These companies appeared to be interlocked, and there are various transactions between the four all related to reopening a coal mine in Montana. CBC's total exposure on this transaction was about $22 million. Its legal lending limit would have been between $6.1 and $6.6 million (2000 - 2001) at the time these deals were made. According to FDIC and State of Connecticut banking officials, there is apparently no requirement under Connecticut law to aggregate or combine loans to different obligors even though the loans directly benefited one another and the expected source of repayment was the same for each loan.

We discussed this issue with Connecticut banking officials, and they agreed that there are loopholes in the law that need to be addressed. According to the Connecticut banking officials, they are in the early stages of drafting proposed changes to the law.

Examiner Concerns Were Frequently Disregarded or Not Fully Addressed

The Bank's Board of Directors and senior management frequently disregarded or did not fully address examiner concerns. These concerns included some basic tenets of banking such as risk diversification, risk management, loan underwriting, and loan administration. Examination reports from 1996 through 2001 identified recurring problems at the bank that required attention. The 1996 examination report disclosed CBC's overall condition as unsatisfactory due to the Board and senior management's slow progress in addressing and resolving long standing asset quality problems and the resultant drain on earnings. Our review of FDIC and State of Connecticut examination reports indicates that while bank management took action on some recommendations, most were not sufficiently addressed, which contributed to the bank's failure.

Onsite examinations are a significant part of the FDIC's supervisory function. The DSC *Manual of Examination Policies* in section 1.1 states that the "examination process can help prevent problem situations from remaining uncorrected and deteriorating to the point where costly financial assistance by the FDIC, or even a payoff of depositors, becomes unavoidable." Further the manual notes "the examination supplies the supervisor with an understanding of the nature, relative seriousness and ultimate cause of a bank's problems, and thus provides a factual foundation to soundly base corrective measures, recommendations and instructions. The examination thus plays a very key role in the supervisory process itself."

Also, the *Manual of Examination Policies* notes that "[t]he capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations should be reflected in the management rating." One of the factors related to the capability and performance of management and the board of directors is its "Responsiveness to recommendations from auditors and supervisory authorities."

Examination reports from 1996 through 2002 cited the following matters for CBC management's attention:

FDIC Report of Examination - December 30, 1996:

- Credit Administration--on-going review, monitoring, and management of the commercial loan portfolio needed improvement. The loan review process was almost nonexistent; documentation required as part of loan agreements was not being received or requested; financial information needed to monitor credits was not being obtained.

- Management--Principal shareholder and Chairman of the Board dominated and controlled CBC's management. This raised issues regarding risk tolerance; loans to entities affiliated with the Chairman or one of his related interests; and the appropriate role for the principal shareholder in the daily operations of CBC.

FDIC Report of Examination - October 20, 1997:

- Asset Quality--the volume of adversely classified assets remained excessive and the past due ratio escalated to an alarming level.

- Asset Administration--documentation, analysis support, and monitoring of assets in the Accounts Receivable Purchase Facility program was inadequate. Two assets were cited for Special Mention. The volume of technical deficiencies in credit files remained high.

- Management--although management and the Board had taken appropriate steps to correct prior deficiencies, substantial weaknesses in other areas were noted. The new deficiencies reflected poorly on management's ability to prevent further problems. In addition, the lack of a strategic plan and budget for 1998 raised questions regarding management's ability to plan and provide critical direction to CBC.

FDIC Report of Examination - October 26, 1998:

- Asset Quality--volume of adversely classified items remained excessive. Efforts to reduce this level were hampered by new classifications. The return of CBC to a satisfactory condition was dependent on efforts to improve overall asset quality.

- Concentrations of Credit--constituted over 400 percent of capital, exposing CBC to a high degree of diversification risk. Management should have implemented a process to adequately identify, measure, and monitor the risks inherent in these types of relationships.

- Management--CBC was operating without a President. Despite this vacancy, senior management took steps toward improving the condition of the institution. However, additional efforts were needed to stabilize earnings performance, reduce problem assets, monitor and administer credit concentrations, and improve internal routine and controls. Also, two directors were noted for having poor attendance at Board meetings.

FDIC and State of Connecticut Department of Banking Report of Examination - December 27, 1999:

- Asset Quality--while improved, remained a concern. Management implemented procedures to strengthen loan administration; however, additional efforts to correct deficiencies were necessary.

- Concentrations of Credit--continued to represent over 400 percent of capital, exposing CBC to a high degree of diversification risk.

- Management--took several appropriate steps to address regulatory concerns. Additional efforts to correct deficiencies in the administration of the loan and lease portfolio and Accounts Receivable Purchase Facility program were necessary.

FDIC and State of Connecticut Department of Banking Report of Examination - March 5, 2001:

The report noted that recommendations from prior examinations had not been satisfactorily addressed. The report stated: "loan administration weaknesses that were noted at the past several examinations still remain outstanding." Also, the report noted deficiencies from the prior two examinations pertaining to the loan loss reserve methodology, internal audit function, and review of the interest rate risk model that had not been fully addressed by management. Further, examiners had concerns in the following areas:

- Asset Quality--the volume and severity of items adversely classified increased substantially since the previous examination. Adversely classified items were an unacceptable 90 percent of Tier 1 Capital and reserves. There was $35 million in assets listed for Special Mention.

- Credit Administration--numerous loans reviewed during the examination contained severe underwriting, credit, and collateral deficiencies. In addition, a substantial number of loan policy exceptions were noted. Numerous imprudent lending practices were identified in loans associated with insiders. There were numerous discrepancies between management's internal risk ratings and the examiners' classifications. Also, there were increases in concentrations of credit.

- Management--the Board's oversight of management was deficient in the loan and compliance areas as well as risk management practices.

FDIC draft Examination Summary Report - April 1, 2002:

- Asset Quality--management and the Board had not appropriately overseen the loan portfolio and loan administration. Loan relationships were not properly monitored, warning signs were not appropriately researched, and loan officers had not been held accountable for their actions. Since the previous examination, management still could not provide meaningful information on many of the numerous credit relationships and had not rectified many of the noted deficiencies.

- Credit Administration and Loan Underwriting--weaknesses remained problematic due to a lack of management oversight, lack of an effective credit policy, and lack of an effective risk assessment.

- Management--the Board and management took action on some previous recommendations; however, the majority of deficiencies were not addressed. The volume of deficiencies identified in the loan portfolio was overwhelming. Loans were not appropriately risk rated, over-advances on factoring lines were prevalent, and appropriate ongoing analysis and monitoring of many credits was not performed.

It is clear from the above examination comments that CBC's Board of Directors showed a pattern of disregard for examiners' reported concerns and recommendations aimed at ensuring that CBC operated in a safe and sound manner. The examiners repeatedly reported oversight deficiencies in loan concentrations, affiliate and insider transactions, asset quality, and credit administration. Management and the Board's failure to address the continued deficiencies in asset quality, problems in credit administration and loan underwriting, year after year, led to massive loan losses and the depletion of CBC's capital.

Nominee Loan Scheme

In addition to the above, several key events leading to the failure were associated with the March 31, 2000 acquisition of MTB Bank. As a condition of the Purchase and Assumption of MTB Bank, CBC was required by the FDIC to increase capital by at least $20 million. In the application submitted to the FDIC to acquire MTB Bank and in subsequent meetings with the FDIC, the Chairman of the Board of Directors of CBC represented to the FDIC that he would personally inject $20 million into CBC to meet a condition for purchasing MTB Bank. In actuality, the Chairman orchestrated a scheme where he caused the bank to make approximately $20 million in nominee loans to various companies he and family members controlled, and associates during the last week of March 2000 (see Appendix II). The proceeds of these loans were eventually turned over to the Chairman and then used to fund the injection of capital into the bank, deceiving regulators into thinking that the capital injection was provided from the Chairman's own funds. The Chairman did not disclose to regulators that the proceeds of these loans would be transferred to him or for his benefit. Most of these loans had severe underwriting deficiencies, and according to DSC examiners, would not have been approved at a bank with prudent credit underwriting procedures and risk standards.

In furtherance of the scheme, during June 2000, the Chairman again caused the bank to approve over $11 million in loans to entities controlled by himself, his children, and/or business associates. Approximately $5.5 million of these loans were channeled to an entity called Peachtree Group (Peachtree). The FDIC's investigation into this matter disclosed that an apparent business associate of the bank's Chairman created Peachtree in June 2000 with a total capital contribution of $10. FDIC examiners discovered that Peachtree ultimately used the money to purchase various non-performing loans from the bank, giving the appearance that a third party was buying the loans without financing from the bank. By selling the non-performing loans to Peachtree prior to June 30, 2000, the bank's condition appeared materially better on its June 30, 2000 Call Report than it actually was. FDIC examiners also identified other loans made between April 2000 and May 2001, the proceeds of which were used to make payments on the various nominee loans made during March and June 2000. As of November 2002, the FDIC estimated that the aggregated outstanding balance of these nominee loans is at least $34 million.

By using funds obtained from the bank through nominee loans, the Chairman was able to circumvent a regulatory requirement to provide a capital injection and misled regulators into thinking that he used his own funds to ultimately purchase MTB Bank. As a result, the March 31, 2000 Call Report did not reflect the actual condition of the bank because capital was in reality overstated by approximately $20 million, given that these nominee loans were generally not made to creditworthy borrowers. In Table 3, we compare bank information as reported by CBC in its Call Reports from the calendar quarter preceding the acquisition to bank information reported in Call Reports after the acquisition on March 31, 2000. In addition, we show what the bank information would have been without reflecting the $20 million injected as part of the nominee loan scheme.

Table 3
Comparison of Bank Information
Before and After Acquisition
($ in thousands)

	Call Report 12/31/99	Call Report 3/31/2000	Actual 3/31/2000
Assets	$99,521	$368,377	$348,377
Loans (net)	$72,990	$226,485	$206,485
Equity Capital	$8,172	$29,845	$9,845
Equity Capital to Assets %	8.21%	8.10%	2.83%

Source: Call Reports

As shown in Table 3 above, when the $20 million “capital infusion” is discounted, the bank was actually operating with equity capital of only 2.8 percent of assets–well below regulatory guidelines and woefully insufficient given the risks in CBC’s loan portfolio. Once examiners determined the effects of the nominee loan scheme and the losses associated with it, the bank was deemed insolvent and closed by the Connecticut Banking Commissioner.

Other Matters

The FDIC concluded that unsafe and unsound practices by CBC’s Board of Directors continued right up until the bank failed. On June 23, 2002, in a special Sunday night meeting of the Board of Directors, the Board approved over $16.8 million of loan extensions, modifications, and new loans. The following day, the bank made over $12.6 million in wire transfers pertaining to these loans. These loans lacked supporting documentation and financial analysis, and one extension was for a nominee loan made during March 2000. The Board breached its responsibilities in approving these loan activities under circumstances that should have caused the Board to question the propriety of the extensions and loans.

The FDIC and State of Connecticut Department of Banking had commenced a joint examination of the bank in April 2002. During the examination, FDIC and state examiners informed the bank that they planned to meet with the Board of Directors on June 25, 2002. According to the FDIC Notice of Charges issued on November 22, 2002, the Chairman and president were concerned that the examination results would show a severe deterioration in the bank's condition since the March 2001 examination. They also feared examiners would take additional regulatory actions. One of these actions would be restricting the bank's ability to extend credit. Accordingly, the Board convened a special Sunday night meeting on June 23, 2002 during which it approved over $16.8 million in loans and extensions of loans. The Board was given no more than 2 days' prior notice of the meeting. The Chairman, president, and other five directors conducted the meeting by telephone and approved the funding of the loans as presented.

The FDIC asserts that the Board approved most of these loans based solely upon oral presentations. Status Reports and other written loan presentations, when prepared, lacked information necessary to make an informed credit decision. The loans involved close business associates of the Chairman and entities he owned or controlled. The most egregious of these transactions were two new loans totaling $11.5 million to companies with no financial history and no apparent capacity to repay the loans. The Connecticut Banking Commissioner ordered the bank closed after being notified of these loans. The FDIC, as receiver, was able to secure the return of the $11.5 million of funds.

ASSESSMENT OF THE FDIC'S SUPERVISION OF THE INSTITUTION

FDIC and State of Connecticut examiners conducted annual examinations of CBC from 1993 until its closure (see Table 4). Examiners repeatedly identified and reported on significant, yet uncorrected, problems at the bank during that time period. As also shown in Table 4, from 1991 until it failed, CBC operated under various supervisory actions. During the March 2001 examination, the first examination conducted after CBC's acquisition of MTB Bank, examiners discovered what appeared to be to be inordinately high loan activity in March 2000. Examiners conducted follow-up work and in June 2001 began a formal investigation under section 10(c) of the FDI Act that eventually uncovered the loan scheme used by the Chairman to fund the purchase of MTB Bank.

Although the FDIC's supervision of the institution generally identified and assessed the risks identified at the bank, we identified three areas where supervision could have been more effective. These areas pertain to: (1) enforcement actions, (2) the approval process for applications, and (3) following up on red flags.

We also determined that the PCA requirements of section 38 of the FDI Act were not fully effective due to the nominee loan activity, other questionable practices, and the improper valuation of bank assets. These problems, once identified, resulted in a precipitous decline in capital and, therefore, PCA's effectiveness at minimizing losses to the insurance fund was limited. Detailed in the pages that follow is our assessment of the FDIC's supervision of the institution, including implementation of the PCA provisions of the FDI Act.

Finding A: Supervision and Enforcement

From 1993 until the bank closed, safety and soundness examinations of CBC were conducted every year. Supervisory and enforcement actions were issued to address the deficiencies noted at examinations. The table below summarizes CBC's examination history and supervisory actions from 1991 until it failed.

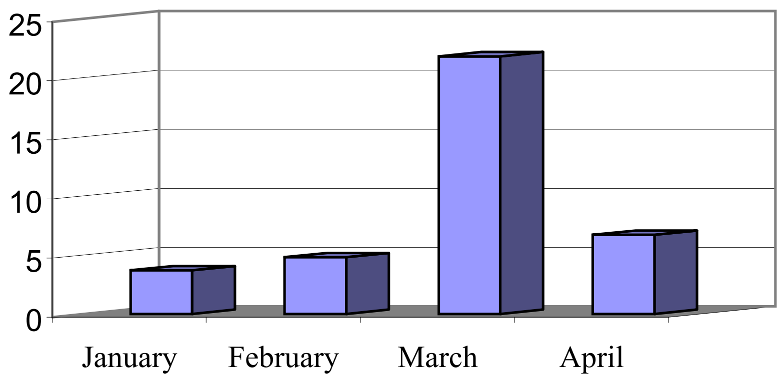
Table 4
FDIC and Connecticut Department of Banking
Examinations and Supervisory Actions for CBC, 1991-2002

Examination Date Started	CAMEL(S)/Composite Ratings	Assets in Millions	Supervisory Action(s) Taken by FDIC and State
12/16/91 FDIC/State	5-5-3-5-3/5	$171	Continuation of Cease & Desist Order as of 7/9/91, regarding bank operations
9/13/93 FDIC	5-5-4-5-3/5	$140	Section 38-Prompt Corrective Action Second C&D as of 12-16-93, regarding management
7/25/94 FDIC	5-5-3-5-3/5	$105	Section 38-Prompt Corrective Action Continuation of C&Ds
9/25/95 FDIC	5-5-3-5-3/5	$84	Section 38-Prompt Corrective Action Continuation of C&Ds
4/15/96 State	5-5-3-5-3/5	$80	Continuation of C&Ds
12/30/96 FDIC	4-4-3-5-2/4	$82	Continuation of C&Ds
10/20/97 FDIC/State	3-4-4-4-3-2/4	$85	Continuation of C&Ds
10/26/98 FDIC/State	3-4-3-3-2-2/3	$87	Memorandum of Understanding as of 3/23/99 replaced two C&Ds
7/12/99 FDIC/State	Visitation -No Rating	$89	Continuation of Memorandum of Understanding
12/27/99 FDIC/State	2-3-3-3-2-2/3	$100	Continuation of Memorandum of Understanding
9/11/00 FDIC/State	Visitation -No Rating	$341	Continuation of Memorandum of Understanding
3/5/01 FDIC/State	3-4-4-3-3-3/4	$397	10(c) Investigation begins in June 2001 C&D Order effective 12/10/01
4/1/02 FDIC/State	Bank closed -No Rating	$407	PCA Directive dismissing the Chairman and President Bank closed before examination report issued

Source: FDIC and State of Connecticut Examination Reports and related correspondence.

At the start of the March 2001 examination, FDIC and State of Connecticut examiners became aware of what appeared to be unusual and irregular activity concerning the volume of loans approved by the bank in the month of March 2000. As discussed earlier in this report, in March 2000, the bank's Board of Directors approved over $20 million in loans when in the prior 2 months, Board-approved loans averaged less than $5 million per month, as shown below in Figure 1.

Figure 1
Loan Approval Patterns - January to April 2000
($ in millions)



The $20 million in loans were funded between March 22, 2000 and March 29, 2000–the week before the MTB acquisition was consummated. These loans appeared suspicious to examiners due to the unusually high volume, lack of information available, and poor underwriting. Also, many of the loans appeared to be connected to the Chairman of the Board. Additionally, the timing of these loans, just days before the Purchase and Assumption occurred, raised concerns with examiners. The stated purposes for most of these loans were for permanent working capital, revolving lines of credit, or unspecified investments. There was no mention in the loan files as to what examiners later learned: the proceeds from these loans would be used to finance CBC's acquisition of MTB Bank. After an extensive investigation, which included substantial tracing of funds, examiners uncovered the loan scheme used by the Chairman of the Board to fund the purchase of MTB Bank.

In addition, examiners discovered as a part of their investigation that during June 2000, the bank approved over $11 million in additional loans to entities controlled by the Chairman, his children, and/or business associates. Approximately $5.5 million of these loans was ultimately channeled to an entity called Peachtree Group (Peachtree). The FDIC's investigation into this matter disclosed that an apparent business associate of the bank's Chairman created Peachtree in June 2000 with a total capital contribution of $10. Examiners discovered that Peachtree used most of the proceeds to purchase various non-performing loans from the bank, giving the appearance that a third party was buying the loans without financing from the bank. By selling the non-performing loans to Peachtree prior to June 30, 2000, the bank's condition appeared materially better on its June 30, 2000 Call Report than it actually was. FDIC examiners also identified other loans made between April 2000 and May 2001, the proceeds of which were used to make payments on the various nominee loans made during March and June 2000. As of November 2002, the FDIC estimated that the aggregated outstanding balance of the nominee loans was at least $34 million. As of December 31, 2002, most of these loans were non-performing, most were lacking in collateral coverage, and according to DRR officials, offered little in potential recoveries.

Enforcement Actions

The bank was under a C&D Order beginning in 1991 and a second C&D Order took effect in 1993. The C&D Orders were removed by the FDIC in March 1999 and simultaneously replaced with an MOU as the bank's condition had apparently improved. The October 1998 FDIC examination upgraded the bank's CAMELS rating from a "4" to "3" largely due to gains in earnings and increased capital. Also, its Tier 1 Capital was 7.86 percent, which was well above the minimum 6 percent requirement per the C&D.

The Regional Office comments from the October 1998 examination stated, "the effectiveness of both the 1991 and 1993 Cease and Desist Orders is considered outdated and unnecessary in view of compliance to date, as well as the basic soundness now evident." An MOU was recommended to address the October 1998 examination findings and require the bank to place specific limits on concentrations of credit, establish targeted reduction levels of total adversely classified assets, maintain continuity of management, maintain a minimum 7.5 percent Tier 1 capital level to offset its higher risk profile, maintain adequate reserves for loan losses, curtail and control consultant costs, maintain tight conflicts of interest policy, and continue to provide quarterly reports.

The FDIC agreed to remove two C&D enforcement actions in March 1999 even though the bank was not in full compliance with the actions. The C&D orders were replaced with an informal MOU despite the fact that the bank remained deficient in its risk management and risk diversification practices, loan administration, and asset quality. Other specific areas of the C&D where the bank did not appear to us to be in compliance included:

- Detailed written Board of Directors meeting minutes with supporting documentation.
- Sufficient level of reserve for loan losses and sufficient methodology for adequacy of reserve for loan losses.
- Correction of loan technical exceptions such as restructuring loan credits or advancing new funds without current financial information.
- Correction of violations of laws and regulations related to internal audit programs and compliance with Bank Secrecy Act requirements.

The DSC Manual of Examination Policy states,

> Banks with composite ratings of "4" or "5" will, by definition, have problems of sufficient severity to warrant formal action. Therefore, the policy of the Division of Supervision is that it shall take formal action pursuant to Section 8 of the FDI Act against all insured State nonmember banks rated "4" or "5," where evidence of unsafe or unsound practices is present. Such formal action will normally consist of either a Cease and Desist Order under either Section 8(b) or 8(c) or initiation of insurance termination proceedings under Section 8(a). Exceptions to the policy may be considered when the condition of the bank clearly reflects significant improvement resulting from an effective corrective program or where individual circumstances strongly mitigate the appropriateness or feasibility of this supervisory tool. For example, acceptable action by

> the State authority might preempt the need for FDIC action, or qualified new management might allow the use of an informal memorandum of understanding instead of a Cease and Desist Order. Mere belief that bank management has recognized the problems and will implement corrective action is not a sufficient basis to preclude action if the bank is still deemed to warrant a composite rating of "3," "4" or "5."

Regarding MOUs, the DSC manual additionally states, as a general rule, and as a minimum, a Memorandum of Understanding is to be considered for all institutions rated a composite "3." Use of an MOU, as opposed to more formal action, is particularly appropriate where the Regional Office believes the problems discussed with management and the board of directors of the institution have been adequately detailed and the institution, in good faith, will move to eliminate the problems.

The DSC chose to replace the C&Ds with an MOU even though it had concerns with asset quality, credit concentrations, and staffing levels. Asset quality was weak. The volume of adversely classified assets had increased since the previous examination and represented 95 percent of Tier 1 Capital and reserves. Credit concentrations were also higher at 429 percent of Tier 1 Capital, representing poor risk diversification, and 31 percent of concentrations were classified as either Substandard or Special Mention. The MOU remained in effect after the acquisition of MTB Bank.

Moreover, regarding enforcement actions, the March 2001examination resulted in the bank being downgraded from a CAMELS "3" rating to a CAMELS "4" rating. In December 2001, the FDIC imposed a new C&D order containing 31 provisions addressing, among other things, credit underwriting and loan administration weaknesses, inappropriate risk rating of loans, insufficient capital, and several repeat apparent violations. While the C&D order contained numerous provisions, it did not necessarily prevent the bank from continuing to make high-risk out-of-territory loans nor did it place a dollar limit on loans to be extended. As a result, the bank continued to make risky loans, funding over $17 million of such loans from January through June 2002, including $13 million just days before CBC failed. While the FDIC was able to recover $11.5 million of the funded loans in its capacity of receiver, almost $6 million was not recovered, and the FDIC estimates that most of this money will not be repaid because the borrowers are not creditworthy and there is a lack of collateral.

While we have concerns about the lifting of the C&D orders in 1999, we are not making any formal recommendations at this time related to that issue. The OIG plans on doing future audit work on a national level that will address the process used by DSC to determine when enforcement actions are implemented and removed.

Regarding the 2001 C&D, with respect to troubled institutions DSC may want to be more proactive in the future and include a provision in the enforcement action that the FDIC receive prior notice of material transactions, out-of-territory lending, or new business activities and be afforded the opportunity to review and comment on same before the institution concludes such transactions or engages in such activities. Such a provision may be appropriate in those cases where an institution's primary business focus is experiencing a downturn or where earnings are deteriorating and a "quick fix" such as investing in highly speculative financial endeavors may be tempting.

Recommendation

We recommend that the Director, DSC:

(1) Include a provision in enforcement actions for certain troubled institutions that the FDIC receive prior notice of material transactions, out-of-territory lending, or proposed new business activities and be afforded the opportunity to review and comment on same before the institution conducts such transactions or engages in such activities.

Finding B: CBC's Application to Purchase MTB Bank

The FDIC did not fully consider the past performance of bank management before approving the application to acquire MTB Bank. This happened, in part, because FDIC guidance addressing the review of management in conjunction with a merger or acquisition is vague and as such, there was no requirement to assess certain specific attributes of management's past performance. The bank had a history of poor management, risky lending, insufficient loan administration, concentrations of credit risk, and questionable compliance with banking laws. These deficiencies were not addressed in the analysis of the application. In total, these management deficiencies raise doubts regarding the FDIC's decision to approve CBC's application to acquire MTB Bank.

Section 18(c) of the FDI Act, 12 U.S.C. 1828, commonly known as the "Bank Merger Act," and the FDIC Statement of Policy on Bank Merger Transactions require the prior written approval of the FDIC before any insured depository institution may merge or consolidate with, purchase or otherwise acquire the assets of, or assume any deposit liabilities of, another insured depository institution if the resulting institution is to be a state nonmember bank. Institutions that undertake a merger transaction as described above must file an application with the FDIC. The Bank Merger Act requires, among other things, that the FDIC consider the financial and managerial resources and future prospects of the existing and proposed institutions. The Bank Merger Act also states that the FDIC normally will not approve a proposed merger transaction where the resulting institution would fail to meet existing capital standards, continue with weak or unsatisfactory management, or whose earnings prospects, both in terms of quantity and quality, are weak, suspect, or doubtful. In evaluating management, the FDIC will rely to a great extent on the supervisory histories of the institutions involved and of the executive officers and directors proposed for the resultant institution. The FDIC, as required by the Community Reinvestment Act (CRA), 12 U.S.C. §2901 et. seq., will also note and consider each institution's Community Reinvestment Act performance evaluation record. An unsatisfactory record may form the basis for denial or conditional approval of an application. Accordingly, each merger application should be evaluated in light of the FDIC's intent and purpose to foster and maintain a safe, efficient, and competitive banking system that meets the needs of the communities served.

The DSC *Case Managers Procedures Manual* provides limited guidance to case managers when assessing management in conjunction with a prospective merger. The guidance states: "Discussion of the general character of management should address ownership and active management of each institution as well as the combined institution. Insider benefits should be fully discussed."

In accordance with its policy, DSC prepared an analysis of the application that evaluated, among other things, the financial and managerial resources of both CBC and MTB Bank. The analysis of CBC management indicated that "Management of CBC has been rated either a component '4' or '3' since the 1990 examination." The management rating at the December 1999 examination remained a "3." The analysis also discussed each person who would be part of the senior management team and noted that the stability of the current management team was viewed as a positive sign.

Our review of the FDIC's analysis of the application found no mention of the fact that the bank had a history of poor management as evidenced by risky lending, insufficient loan administration, concentrations of credit risk, questionable compliance with banking laws, and insufficient responsiveness to examiner recommendations. It appears that the analysis was focused more on the condition of the bank and the Chairman's reported wealth and prior willingness to inject substantial capital into the institution. In our opinion, the history of management deficiencies at the bank raises doubts about the FDIC's decision to approve CBC's acquisition of MTB Bank.

Further, related to the application review, the FDIC did not adequately validate and review the financial status of the Chairman of the Board–the source of the capital injection required for the Purchase and Assumption. While the FDIC's Statement of Policy on Bank Merger Transactions and the *Case Managers Procedures Manual* require the assessment of the financial resources of the existing and proposed institutions, there is no requirement to validate the financial capability of a would-be investor. As a result, the FDIC did not verify the financial information submitted regarding the source of the capital injection and, accordingly, had no assurance that the principal shareholder was, in fact, injecting the required amount of capital from his personal assets as agreed to with the regulators.

In its application, CBC represented that its majority shareholder would inject $20 million into the bank to purchase $10 million in common stock and $10 million in preferred stock, the proceeds of which would be used to fund the acquisition transaction. According to DSC officials in Boston, the majority shareholder represented that the $20 million would come from his own personal assets. In order to assess his ability to provide the $20 million, the FDIC requested and received a financial statement from the majority shareholder. DSC officials at the Boston Area Office told us that they did not verify the information contained in the financial statement. Our review showed that the financial statement was self-prepared, unaudited, lacked details, and contained no supporting documentation. As a result, the financial statement was not sufficient to determine the financial condition of the Chairman and provided little support or explanation for the source of the $20 million capital injection.

Lastly, regarding the application review process, the CRA[15] performance evaluation (CRA PE) for CBC performed in late 1999, prior to the acquisition of MTB Bank, did not reflect the bank's actual performance. Instead the rating was based on the bank's performance context[16] and future projections of performance. Because the majority of the bank's lending was outside of its assessment areas by design, in the OIG's view, the lending appeared not to meet the conditions

[15] The CRA was enacted as Title VIII of the Housing and Community Development Act of 1977 and applies to all federally insured financial institutions, excluding credit unions. CRA requires that financial regulatory agencies evaluate institutions' CRA performance and requires that these evaluations be disclosed to the public. In 1995, the regulation was revised to emphasize performance rather than process, to promote consistency in evaluations, and to eliminate unnecessary burden. The new rules require banks to meet the lending, service, and investment needs of the communities where they accept deposits, and require that examinations focus on tangible performance-based results rather than on procedures.

[16] A bank's performance context takes into account its financial capacity and size, legal impediments, and local economic conditions and demographics, including the competitive environment in which it operates.

of a "Satisfactory" CRA rating.[17] As a result, the rating may not have been an appropriate one on which to base approval of the bank's application to acquire MTB Bank.

According to 12 C.F.R. 303.5, CRA ratings are to be taken into consideration as part of the merger application review process, and an unsatisfactory record may form the basis for denial or conditional approval of an application. In August 1999, the former FDIC Division of Compliance and Consumer Affairs initiated a full scope CRA PE for CBC. The Examiner-in-Charge (EIC) initially rated the bank a "Needs to Improve" due to its huge volume of out-of-territory lending, low lending in low- and moderate-income areas, and the lack of small business loans. The CRA PE reported the following:

- Although the bank's loan-to-deposit ratio averaged 77 percent, much of the lending included in the ratio benefited areas outside of the bank's assessment areas and beyond the state of Connecticut.

- Based on the bank's data, it appears that 70 percent of the loans originated by the bank were inside its assessment areas; however, the ratio is misleading as the lease finance receivables were originated to one local company but did not primarily benefit businesses or individuals inside the bank's assessment areas. The financial benefits of these leases were to companies located throughout the United States, with several benefiting foreign and offshore companies.

- A majority of the bank's mortgage loans by both number (63 percent) and dollar amount (66 percent) were made outside the bank's assessment areas. For those loans made inside the bank's assessment areas, the geographic distribution of the mortgage loans appeared favorable; however, only 24 percent of the census tracts were penetrated, and none of the loans were made in any of the area's low-income census tracts.

- The percentage of consumer loans originated inside the assessment areas was 69 percent; however, the percentage measured by dollar showed that a majority had been lent outside the assessment areas. The bank's consumer loan portfolio accounted for 11.5 percent of the bank's total loan originations by dollar amount.

- The bank's level of small business lending within the community, both by number of loans and dollar amount, was considered inadequate. Less than a majority of small business loans (22 percent in total) were made within the assessment areas during the evaluation period; however, census data showed that 95 percent of the business establishments in the bank's assessment areas were small businesses.

[17] CRA performance is rated according to a four-tiered system: Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance. Banks given Satisfactory ratings are considered to have a satisfactory record of helping meet the credit needs of their assessment areas, including low- and moderate-income neighborhoods, in a manner consistent with their resources and capabilities.

- Only 10 percent of all census tracts inside the assessment areas were penetrated in the small business loan portfolio, indicating a lack of geographic dispersion. The small business lending data for other banks in the area showed that loans were, in fact, made by other banks in each of the census tracts in the bank's assessment areas, which demonstrated that lending opportunities existed.

After being informed of the preliminary rating, the bank’s president wrote a letter to the FDIC EIC to document the constraints posed by the bank's performance context. The bank argued that it had experienced several lending constraints during the period under review that included a large portfolio of non-performing loans, poor earnings, and regulatory enforcement. Also, in an effort to return the bank to profitability, bank management had focused its lending efforts on two profitable market niches: lease finance receivables and accounts receivable lending. The EIC noted that the benefit realized by the communities in which the bank operated was minimal. The EIC also reviewed the other performance context issues raised by the bank and found that the bank's assessment areas were booming and there was no reason why the bank could not make loans. He looked at other banks in the area and their data showed that lending opportunities were good, no major employer had closed down in the area, and the bank was returning to profitability.

Despite these findings, the EIC said that DCA management decided to change the rating from a “Needs to Improve” to “Satisfactory.” The transmittal letter sent to the bank noted, "CBC's CRA performance is assigned a rating of ‘Satisfactory’ based largely on performance context and less so on actual performance.” In addition, according to the CRA report, "The satisfactory CRA rating assigned is largely based on the performance context, given that the actual penetration and dispersion of lending within the bank's assessment areas during the past two and one-half years warrants significant improvement."

According to the Community Reinvestment Act, a bank should be evaluated based on actual performance and not on future projections of performance. Based on our review of the PE, CRA examination workpaper files, and related correspondence, the "Satisfactory" rating assigned did not reflect the actual CRA performance of the bank. Although the EIC's initial rating was "Needs to Improve," after several meetings with bank management, the rating was upgraded to “Satisfactory." However, we found no support justifying the change in rating based on performance context issues.

Although CRA regulations, 12 C.F.R. §345.21, allow examiners to consider the institution’s performance context when assigning CRA ratings, it appears that the performance context factors were not applicable in the case of CBC. There was lack of evidence to support the bank’s contention that operating under formal and informal enforcement actions forced it to lend outside its assessment areas. Also, there was no evidence in the examination workpapers documenting economic issues or unusual demographics related to the bank's lending area, such as: (1) high unemployment in the area; (2) a major business or employer closing down; or (3) a prison, reservation, or military installation in the area. These types of performance context issues could cause the demographics of the community to appear to reflect more potential borrowers than actually exist, or they could have adverse effects on a bank's lending levels. We also found that although the bank was returning to profitability, it continued a pattern of extensive lending outside of its assessment areas. The strategy to lend outside of the bank's assessment areas was the bank's decision and showed a lack of commitment to the community in which it was operating.

Based on our review of CRA workpapers and follow-up discussions with the EIC and the Review Examiner, we did not find convincing evidence to support the "Satisfactory" CRA rating assigned. The rating appears to be based solely on the bank's projected performance and not on its actual performance during the time period under review. As a result, the rating may not have been an appropriate one on which to base the approval of the bank's merger application to acquire MTB Bank.

Recommendations

We recommend that the Director, DSC:

(2) Revise the *Case Managers Procedures Manual* to ensure that bank management is fully assessed before approving applications for mergers and acquisitions. This should include analyzing all aspects of corporate governance and examining management's past responsiveness to recommendations made in examination reports.

(3) Regarding capital injections in conjunction with an acquisition, merger, or change of control application, require: (a) acquirers to specify the source of funding in the application package and provide proof the funds are available (this could include requesting tax returns, bank and broker statements, audited financial statements, and any other information deemed necessary to validate the source of funding) and (b) DSC to review and validate the information submitted by acquirers prior to executing the transaction, and document resulting determinations.

(4) Require field office examiners and regional office staff to fully document the rationale behind the decision-making process related to assigning CRA ratings that are based on special circumstances and not on a bank's actual CRA performance during the period under review. At a minimum, the documentation should include the rationale for assigning the CRA rating, a summary of DSC senior management's discussions with bank management, an explanation of the special circumstances considered, and a planned approach for periodic follow-up visits, offsite monitoring, or periodic reporting by the bank.

Finding C: Following Up on Red Flags

Examiners did not always follow up on red flags discovered during examinations prior to the acquisition of MTB Bank. In particular, weak corporate governance and a poor internal control structure, both of which were identified by examiners (and discussed previously in this report), should have heightened the attention given by examiners to some questionable transactions. Red flags that warranted more in-depth review included: (1) the bank booking approximately $4.5 million for a residual interest in four 727 cargo planes; (2) instances at the bank where adversely classified loans were modified or paid off between examinations; and (3) the bank effectively circumventing legal lending limits by structuring transactions as purchases rather than loans. A more in-depth review by examiners might have revealed that the cargo planes were not properly valued, some loans may have been renewed or restructured rather than paid off, and the purchase transactions were in-substance loans and in violation of Connecticut legal lending limits.

Guidance provided by DSC to examiners states that it is essential for examiners to be alert for irregular or unusual activity and to fully investigate the circumstances surrounding the activity. Red flags should be reviewed thoroughly to determine whether there is any substance to them. As necessary, field personnel should perform additional work as necessary to ensure that the matters are resolved promptly. Our review of examination reports and related records shows that questionable management practices were evident at CBC for many years. For the most part, examiners identified these questionable practices and criticized bank management in examination reports. Yet, we noted some bank practices and transactions prior to the acquisition of MTB Bank that may have warranted more in-depth review by examiners.

<u>Review of Cargo Planes</u>

From 1997 until it failed, the bank's financial statements reflected the residual value of its interest in four Boeing 727 cargo aircraft. The bank's interest in these aircraft resulted from a 1995 transaction in which the bank purchased $7.3 million in medical equipment for a leasing arrangement. During 1997, in a complex transaction, the bank transferred legal title of the medical equipment to an apparent affiliated party of the original seller of the equipment. As part of the transaction, the bank received an interest in the residual value of four aircraft. The bank estimated the value of that interest at approximately $4.5 million in 1997, at a time when its equity capital was about $6.5 million. According to bank records and information we obtained from DRR, the cargo planes were physically located in the United Kingdom and they were not authorized to fly in the United States because they apparently could not comply with noise abatement laws.

Our review of this transaction identified concerns about the bank's valuation of its interest in the planes and whether or not it had legal title and had perfected its interest in the planes. Specifically, file documentation was lacking and the terms of the transaction were vague, an onsite appraisal was not performed, and there was no definitive evidence that the bank had secured proper title to the aircraft. According to DRR officials, it appears these planes were sold in 2001 for approximately $2.5 million, and the bank received nothing from the sale of the planes. This transaction was never disclosed to FDIC or State of Connecticut banking officials. Examiners reviewed this transaction at every examination from 1996 forward and raised many of the same concerns over collateral valuation and the bank's ownership interest but apparently relied on a "desk top" appraisal that indicated the planes were worth over $14 million. As shown in the table below, this asset represented a significant part of the bank's equity capital from 1997 through 1999.

Table 5
Carrying Value of Cargo Planes
as a Percent of Equity Capital
($ in thousands)

	1997	1998	1999
Value of Planes	$4,459	$4,459	$4,440
Equity Capital	$6,490	$6,937	$8,172
Percent of Capital	68.7%	64.3%	54.3%

Source: OIG analysis

Our review of this asset identified a number of red flags concerning the value assigned by the bank. Specifically:

- File documentation was lacking and terms were vague. There was insufficient information to explain how the asset changed from a leasing of medical equipment arrangement to a residual interest in cargo aircraft. Further, the value of the aircraft should have appeared suspicious based on information in the bank's 1997 audited financial statements that indicated the bank purchased the medical equipment for $6.3 million, yet sold its interest in the medical equipment to the lessee for $2.2 million. Based on that information, it appears CBC's carrying value of the cargo aircraft was significantly higher than the value of the equipment. Lastly, information identifying whether CBC's ownership interest was subordinate to another party's interest, as it appears to have been, was not clear.

- An onsite appraisal was not performed. The bank only obtained "desktop" appraisals for this asset. The appraiser relied on the value of comparable aircraft in published sources of secondary market information and discussions with brokers and dealers. As a result, critical information such as the condition of the planes, engine age, flight hours, and maintenance records were not considered in the planes' valuation.

- The bank's legal ownership right to the planes was in question. No title information was available and it is unclear whether the bank was the first lien holder or in a subordinated position as to legal right to proceeds in a sale of the planes. Further complicating the valuation was that the planes were apparently located in the United Kingdom and did not meet the Federal Aviation Administration requirements to fly in the United States.

Because this asset represented 68 percent of the bank's equity capital in 1997, we believe this transaction warranted more in-depth review. While examiners raised many of the same concerns identified above, they appeared to rely mostly on the value contained in the desktop appraisal.

Reviewing Loans Modified/Paid Off

Some adversely classified assets, subsequently brought current or paid off, may have warranted further review to determine the integrity of the transactions. Some examiners we interviewed told us that it was not unusual for them to classify an asset at the bank and at the next examination discover that the asset had been paid off or restructured. Examiners told us that they generally do not review assets that have been repaid and are no longer on the bank's books. We found one line of credit totaling $9.4 million and representing over 138 percent of capital that raises many questions, including the source of payment and whether loans in the line of credit were in fact repaid. Renewing or restructuring non-performing loans can make a bank's condition appear better than it is and forestall regulatory actions.

Our review of examination reports indicates that examiners devoted a significant amount of time during examinations reviewing CBC's loan portfolio. Examiners frequently reviewed over 50 percent of the loan portfolio due to the bank's poor condition and risky lending practices. Examiners informed us that they generally do not review a loan file if the loan has been paid off. One line of credit (line) pertaining to an oil operation in Canada apparently originated sometime in 1997 may have warranted further review. Examiners identified this loan as a concern in the 1998 FDIC and State of Connecticut examination reports. The total outstanding amount of this line was $9.4 million–approximately 138 percent of capital. The loans associated with this line represented a complex legal and operating structure involving several interrelated companies and their principals. The loans were used to fund various aspects of an oil processing and distribution facility in Alberta, Canada. Red flags associated with this line included the following:

- Loans associated with this line were frequently modified and/or delinquent. A March 31, 1998 status report indicated that seven of the loans in the line were delinquent, ranging from 31 days to 152 days.

- Related to the March 31, 1998 status report, examiners discovered that one of the loans shown on the status report as 36 days delinquent was in fact 126 days delinquent. Bank management could not explain why the system did not reflect the actual number of delinquent days.

- Between the 1998 and 1999 examinations, in a series of convoluted transactions, some of the loans were either restructured, sold to a company controlled by CBC's Chairman, or paid off. Also, a guarantor of the line with strong financial capability was released from his obligations without explanation. The line was reduced by over $6 million, but it was unclear where the payments came from.

Records related to these transactions indicate examiners reviewed these transactions and inquired about their status with bank personnel. However, in correspondence we reviewed, bank personnel appeared evasive in their answers. Examiners we interviewed said they verified that payments had been made but did not review payments to determine their source or determine whether these were arms-length transactions. According to information obtained from the 2002 examination, the outstanding balance on loans related to this line was over $8 million.

<u>Avoiding Legal Lending Limits</u>

Starting in 1997, the bank made a number of loans that appeared to exceed the legal lending limits of the State of Connecticut. The bank lent millions of dollars for what it termed accounts receivable purchase facilities. The bank asserted that the accounts receivable purchase facilities were not loans but rather the outright purchase of the borrower's accounts receivable. By structuring the deals as purchases, the bank contended that each underlying accounts receivable was the de facto borrower and thus only the individual accounts receivable amount would be applicable to the legal lending limits of the State of Connecticut. Between 1997 and 1999, when its legal lending limit ranged from $1.24 million to $1.53 million, the bank lent money to several borrowers for accounts receivable purchases in excess of that amount, ranging as high as $10 million to one borrower. Examiners noted that the "loans acquired under the Receivable Purchase Facility Program appear, in substance, to be direct loans to the companies rather than account receivables." However, after receiving a legal opinion from the bank's attorney suggesting otherwise, the matter was not pursued. By December 31, 1999, accounts receivable purchases represented approximately 28 percent of the bank's total loan and lease portfolio. Several of these transactions were in excess of the bank's legal lending limit. According to DRR records, one of these transactions with a book value over $6.5 million was sold in October 2002 for approximately $1.75 million, less than 27 percent of its book value.

As previously discussed in this report, the bank originated a number of these transactions that appeared to exceed the legal lending limits of the State of Connecticut. Because this was a state banking law, FDIC examiners deferred to the State of Connecticut Department of Banking on this matter. The bank's attorney wrote various legal opinions explaining why these transactions would not be subject to legal lending limits. We discussed this matter with Connecticut Department of Banking officials. They explained to us that the legal lending limit laws are somewhat ambiguous, and they determined that the transactions, as purchases of receivables, would likely be legal under existing Connecticut law. Connecticut banking officials also informed us that they discussed the matter internally but did not ask for a formal legal opinion from their own attorneys, stating that because the law was vague, the bank's interpretation of it would be difficult to refute.

However, from evidence we reviewed, these transactions appear to have been purposely structured in a manner to avoid the legal lending limits. For example, examiners noted that the individual accounts receivable were not required to make payment to a lock box controlled by the bank, suggesting a lack of direct obligation of the receivable to the bank and lack of control by the bank. Examiners also noted that information about the accounts receivable was not in many files; therefore, the actual obligors were not known. Also, there were no documented onsite reviews of the obligors, or documented reviews of the obligors' creditworthiness by the bank.

During 2000, DSC began a series of initiatives for examiners in detecting fraud during safety and soundness examinations. Three Regional Director Memorandums addressing fraud and internal controls were issued during February and March 2000. Additionally, DSC initiated enhanced examiner training in the area of fraud detection and internal controls and the detection of fraud indicators, commonly referred to as red flags. All examiners were required to attend a refresher course for training in fraud detection techniques and each regional office implemented an on-the-job training program. Because most of the aforementioned red flags occurred prior to this training, we are not making any recommendations in this report addressing the investigation of red flags.

However, we offer the following recommendation regarding legal lending limits and their importance in helping to protect the safety and soundness of banks by preventing excessive loans to one person and promoting risk diversification.

Recommendation

We recommend the Director, DSC:

(5) Encourage examiners to work collaboratively with state examiners at resolving issues related to state banking laws, particularly when those issues directly affect the safety and soundness of an institution. This would include seeking advice from counsel.

Finding D: Implementation of Prompt Corrective Action

Once DSC identified the effects of the nominee loan scheme, it notified the bank of its capital category and promptly took discretionary actions available under PCA. However, PCA's effectiveness at minimizing losses to the insurance fund was limited because the Chairman's nominee loan scheme artificially inflated capital and, once detected, caused a precipitous decline in capital. PCA's effectiveness was further limited by the bank overstating its capital each year since 1997.

PCA was incorporated into the FDI Act under Section 38, effective December 19, 1992. PCA aims to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund. For those institutions that do not meet minimal capital standards, regulators may impose restrictions on dividend payments, limit management fees, cur asset growth, and restrict activities that pose excessive risk to the institution. Section 38 of the FDI Act defines five capital categories for insured financial institutions as follows: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The section requires specific supervisory actions to occur when the financial institutions fall into any one of the lower three capital categories. PCA supplements the use of other available enforcement tools (e.g., Cease and Desist Orders, Section 8(e) removal of an institution-affiliated party, civil money penalties) that may address unsafe and unsound banking practices before capital becomes impaired.

CBC experienced capital deficiencies from 1991 until 1996 as a result of poor asset quality. FDIC and state regulators imposed two C&D Orders (1991 and 1993) that required the bank to submit various capital plans and to maintain minimum capital levels. Despite several capital injections by the Chairman of the Board of Directors totaling over $17 million in the early 1990s, the bank remained undercapitalized until 1996. The C&D Orders generally required higher capital than was required under PCA due to the high risks identified by examiners at the bank. In December 1996, CBC's PCA capital category reached an acceptable position of "adequately capitalized" and remained adequately capitalized until 1999, when it became "well-capitalized." In March 1999, the two C&D Orders were replaced by an MOU, which is an informal action not enforceable in court. The MOU also set capital levels higher than the minimum requirements due to the riskier lending and asset purchase transactions undertaken by CBC management.

In the March 2001 examination, capital levels remained above the MOU requirement and capital was considered marginal. A C&D Order that became effective in December 2001 addressed the deficiencies of the bank and included a requirement to maintain Tier 1 capital at a minimum level of 7.5 percent. During an examination begun in April 2002, when the effects of the nominee loans were realized, capital was immediately exhausted and the bank's PCA capital category became "critically undercapitalized." A minimum capital injection of $34.3 million was needed to bring capital within compliance of the provision of the December 2001 C&D Order. On June 25, 2002, the FDIC issued a PCA Directive ordering the dismissal of the Chairman of the Board and the president from the bank.

As previously mentioned, from 1997 until CBC failed in 2002, the bank had booked a residual interest in four 727 cargo planes. The value of this interest ranged from $4 million to

$5.2 million during that period. In actuality, the value of these cargo planes was significantly less, but the bank was able to hide that fact from examiners. Had the $4.5 million been deducted from CBC's capital account, the bank would have had a PCA capital category of "critically undercapitalized" from 1997 forward and would have been prevented from acquiring MTB Bank due to the capital deficiency.

When a bank is determined to have capital ratios lower than those appropriate for the bank, the manner in which a capital plan is developed and submitted to the FDIC will depend largely on the nature of any other corrective measures (capital directive, PCA directive, C&D Order, or MOU) that will be taken. CBC had other enforcement actions imposed prior to and after the enactment of PCA. The capital requirements of the other enforcement actions were stricter than the PCA requirements. However, the substantial drop in capital that resulted from the nominee loan scheme, the inappropriate valuation of the cargo aircraft, and other questionable asset valuations limited the effectiveness of PCA at minimizing losses to the BIF.

We are not making any formal recommendations at this time regarding the implementation of PCA. The OIG is currently performing a detailed review of PCA and its effectiveness, as it pertains to FDIC-supervised banks. We will incorporate the results of CBC in that report, as appropriate. We anticipate issuing the final report during the third quarter of 2003.

CORPORATION AND STATE OF CONNECTICUT COMMENTS AND OIG EVALUATION

On March 6, 2003, the DSC Director provided a written response to the draft report. The response is presented in its entirety as Appendix IV to this report. DSC "fundamentally" agreed with four of the five recommendations. Although DSC disagreed with one recommendation, the division is taking an alternative corrective action that appears to address the intent of the recommendation. Accordingly, we consider all five recommendations to be resolved, but the recommendations will remain undispositioned and open until we have determined that corrective action has been taken and is effective.

Prior to responding to the report's five recommendations, DSC provided comments on certain parts of the report. Those comments are bulleted below, followed by the OIG's evaluation of those comments, in italics.

- <u>Disclosure of Privileged and/or Predecisional Information</u>

  In its response, DSC expresses concern related to disclosure of privileged and/or predecisional information in our report, in light of pending administrative and civil litigation arising out of the failure of CBC and the conduct of CBC's Chairman and President. The FDIC's Legal Division expressed similar concerns earlier.

  We previously invited the Corporation to identify specific information that it considered privileged, but no specific information of concern has been identified. In requiring us to perform a material loss review under Section 38 of the FDI Act, the Congress specifically eliminated exemptions from public disclosure that may be invoked by the government to shield from release information that is predecisional in nature. In doing so, the Congress concluded that the importance of full and public discussion of the supervision of failed institutions is greater than the need to protect from public release information pertaining to the relevant predecisional processes of a Federal regulator. Accordingly, while we understand the concerns expressed by DSC and the Legal Division, our discussion in this report of the actions of the FDIC as supervisor of CBC is necessary to fully discharge our statutory obligation to conduct this review and is consistent with the requirements of the FDI Act and the Congressional intent embodied in the Act.

- <u>Cause of Failure</u>

  DSC disagrees with the OIG's conclusion that CBC failed and resulted in a material loss to the Bank Insurance Fund (BIF) because of ineffective corporate governance. It is DSC's position that "the proximate cause of CBC's failure was insider fraud in the form of nominee loans totaling at least $34 million." DSC further notes that ineffective corporate governance resulted in excessive risk taking, disregard for laws and regulations, and questionable asset valuations–all of which exacerbated the potential loss to the FDIC. DSC states that high-risk lending combined with poor risk management practices caused significant losses for CBC prior to failure and has resulted in deep discounts on assets sold by the FDIC. As receiver, the FDIC has also realized significant losses on the liquidation of certain other assets.

However, DSC contends that the largest contributing factor to CBC's failure and the material loss to the FDIC was fraud perpetrated by insiders of the bank.

We agree that the nominee loan schemes were a key component of the material loss to the BIF and ultimately resulted in the bank's closure. However, in our opinion, the loan schemes were the proximate cause of the bank's closure, not the failure, which we believe is an important distinction. However, our review of CBC disclosed a failure by its Board of Directors and senior management to operate the bank in a safe and sound manner for many years prior to the bank's closure as noted in DSC's response. As discussed in this report, had examiners or the independent auditor uncovered the true nature of various transactions and determined the proper valuation of certain material assets earlier, the bank may have been declared critically undercapitalized before June 2002. As DSC explains in its response, the reported capital of CBC on March 31, 2002 was over $29 million. As of December 31, 2002 the FDIC estimates the loss to the BIF associated with this failure at $63 million. Assuming the FDIC receives nothing for the $34 million in nominee loans, the magnitude of the loss indicates that other activities allowed to occur both before and after the nominee loans as a result of ineffective corporate governance, significantly contributed to the demise of this bank and resulting material loss.

- Scope of Fraud Investigation

DSC stated that "the OIG's comments throughout the Draft Report do not accurately depict the complexity of the nominee loan schemes at CBC or the scope of the investigation necessary to fully uncover the magnitude of the fraud."

Our report discusses at length the nominee loan scheme and the 10(c) investigation into the scheme that resulted from the March 2001 examination. We reiterate that DSC conducted a lengthy, complex, and thorough investigation that ultimately uncovered the nominee loan schemes and led to the bank's closure. We also have noted as such in our transmittal of this report to the Congress and the Comptroller General of the United States.

- Interest in Cargo Planes

DSC believes the OIG's conclusion regarding CBC's interest in the cargo planes is unfounded. DSC states the following:

> The OIG apparently assumes that if CBC or the FDIC as receiver eventually received nothing from the sale of the planes that the asset never had value and should have been charged off in 1997. In reality, asset values fluctuate and residual interests are generally much more volatile than the value of the underlying asset. The OIG cannot impeach the historical value of the cargo planes based on subsequent events. More specifically, it is not fair to assume that the asset had no value in 1997 (and forward) based on events in 2001 and/or 2002. … At the 1996 examination, CBC's interest in the four cargo planes was reviewed by a senior FDIC examiner and capital markets specialist. (This examiner was not interviewed by the OIG.) The examiner concluded that there were no credit or administrative weaknesses associated with the transaction.

Our concerns regarding the cargo planes stemmed from a number of red flags surrounding this asset that we believe warranted further review. In addition to the complexity of the transaction, there was insufficient evidence in the bank's file to properly assess the valuation of the planes and to determine the extent of the bank's residual interest. Of particular concern was examiners' reliance on a "desktop" appraisal that lacked critical information as to the planes' airworthiness, engine hours, and maintenance records. Also, file documentation was lacking to determine whether the bank held proper title to the asset and whether or not it had perfected a lien against the asset. Additionally, the fact that these planes were not located in the United States should have raised examiners' concerns.

With respect to DSC's concern that we did not interview the examiner involved in the 1996 examination, the bank's interest in the cargo planes was not reported on its balance sheet until 1997. Accordingly, we interviewed examiners from the 1997, 1998, 1999, and 2001 examinations about this particular asset.

With regard to the true value of the planes in 1997, we note that the bank's interest in the planes resulted from a complex transaction in which the bank transferred legal title of medical equipment in exchange for a residual value of the aircraft. This medical equipment was another investment in which the bank had lost money and the bank was apparently trying to mask the loss in its financial statements by entering into this transaction involving the aircraft. The value of the medical equipment at the time of the transaction, based on the bank's 1997 financial statements, was $2.2 million - considerably less than the original $6.3 million purchase price.

Nevertheless, in recognition of DSC's comments, we have clarified our report to reflect the uncertain value of the planes in 1997 and its impact on the institution's capital rather than the presentation in the draft report which made it appear with certainty that the planes had no value at that time.

- <u>Acquisition of MTB Bank</u>

  DSC notes that it conducted an extensive analysis of the proposed management team of the resultant bank. Under the proposal, CBC would obtain three additional outside directors from MTB, six senior officers from MTB, and three completely new senior officers to be hired due to the acquisition. The addition of three outside directors and nine senior officers was viewed favorably, and many of the officers would fill positions in areas where deficiencies had been identified.

  DSC also stated that it clearly had concerns regarding the prior history of poor management at CBC. However, DSC determined that the improvement in management's responsiveness and the potential to add many new qualified members to the management team outweighed its reservations regarding CBC's past regulatory troubles. DSC also noted that the 1998 and 1999 Reports of Examination "saw an increased effort by management to adhere to regulatory recommendations and implement corrective actions."

  In the analysis of the application, DSC commented extensively on proposed senior management and Directors of the bank and noted that this would favorably impact the bank.

However, we did not see any evidence in DSC's analysis that addressed the lack of corporate governance at the bank and past deficiencies identified at every examination, many of which remained uncorrected. Uncorrected deficiencies included poor risk management and risk diversification practices, weak underwriting, and frequent under-funding of the ALLL. We believe these are serious deficiencies that should have caused DSC to more fully deliberate on the advisability of the acquisition. In addition, there was no mention in the analysis of the bank's responsiveness to examiner recommendations even though DSC's own guidance to examiners provides that one of the factors related to the capability and performance of management and the board of directors is its responsiveness to recommendations from auditors and supervisory authorities.

The analysis appeared to emphasize the cash being injected into the bank by the Chairman and prior cash injections by the Chairman. The analysis noted the Chairman's "wealth is a source of financial strength to the bank, and he has demonstrated a willingness and ability to meet every request for recapitalization since acquiring the bank in 1992, which at the time was on the verge of failure."

- <u>Enforcement Actions</u>

DSC states that while CBC may not have been in compliance with every provision of the C&D Orders, management's efforts to comply with the enforcement actions had improved considerably. Also, for enforcement actions issued in 1991 and 1993, many of the provisions were no longer applicable because CBC's business activities had changed or the actions themselves did not address new activities and deficiencies that DSC was most concerned with in 1999. Given management's better efforts to adhere to regulatory recommendations at that time, the bank's improving financial condition, the bank's "3" Composite rating, and management's willingness to sign the MOU, DSC did not pursue replacing the C&D Orders with a formal enforcement action.

Although the OIG has concerns about the lifting of the C&D Order when the bank did not appear to be in substantial compliance, we did not make any recommendation in this area. We are concerned that if a bank is not complying with a legally enforceable order, it seems unlikely to us that a bank would comply with an even less restrictive supervisory action like an MOU. DSC guidance provides that an MOU may be more appropriate than a formal action when management of the institution has, in good faith, addressed problems. Because CBC management refused to provide detailed written Board of Directors' meeting minutes, failed to develop a sufficient methodology for the ALLL, and did not correct violations of law and loan technical exceptions, we questioned the removal of the C&D Order.

- <u>Examiner Concerns Ignored</u>

DSC's response states that the bank attempted to address DSC's concerns in certain areas, but while the bank's actions were positive, DSC was not fully satisfied and certain criticisms were repeated. Other times, management implemented some specific recommendations fully but new deficiencies would be found in other areas. Also, as DSC pointed out elsewhere in its response, the 1998 and 1999 examinations noted marked improvement in management's efforts to address regulatory issues and the outstanding enforcement actions.

We recognize that the bank addressed some examiner concerns, but most were not addressed, as evidenced by the 2001 Report of Examination that reported on deficiencies in the following significant areas: loan administration, ALLL methodology, internal audit, and other matters that had been identified in previous examinations.

- <u>Community Reinvestment Act Rating</u>

  According to DSC, the CRA rating did not contribute to the bank's failure and appears to be outside the scope of the material loss review. DSC also disagreed with our conclusion that the bank's rating was based on projected performance and believes the rating of satisfactory was sound, noting "lending efforts were hampered by a large portfolio of non-performing loans, poor earnings, regulatory enforcement actions, and a reduction in personnel."

  We reviewed the 1999 CRA examination report because it was applicable to CBC's application to acquire MTB Bank - a key event in the bank's history. The Bank Merger Act requires that a bank's CRA rating be assessed in conjunction with any applications submitted by a bank.

  The CRA Performance Examination report indicated the bank was not satisfactorily lending in its assessment area. Based on information that we reviewed, there was insufficient evidence to support the contention that performance context issues forced the bank to lend extensively outside its assessment areas. The bank made a significant number of out-of-territory loans for accounts receivable purchase facilities – a labor intensive business. Such loan activity would involve substantial staff resources and appears to contradict the statement that lending efforts in the bank's assessment areas were hampered because the bank faced reductions in personnel. Based on the above, we contend that the examiner's original rating of "Needs to Improve" (rather than "Satisfactory") was sound.

- <u>Other Concerns</u>

  In the introduction to its response, DSC states that the draft report was dated February 26, 2003 and was received on March 4, 2003. In addition, DSC expressed concerns about responding to a draft report that "continues to undergo changes."

  The response as written is misleading. On February 12, 2003, we met with several DSC officials and explained in detail the contents of the report. Also at that meeting, we provided DSC officials a copy of the report's recommendations. Recognizing that the congressionally mandated deadline for issuing material loss reviews does not usually allow us to provide DSC the typical comment period, we provided DSC an advance copy of the draft report on February 21, 2003, so they could begin formulating their written response. On February 26, 2003 we issued an electronic version of the official draft to DSC and on February 27, 2003 hand-carried 20 copies of the report to DSC officials in Washington DC. Mostly at the request of DSC and the FDIC Legal Division, we subsequently made some minor changes to the draft report to help provide clarity and ensure factual accuracy.

Under section 38(k) of the FDI Act, we are required to issue the final version of a material loss review report within 6 months after determining that a material loss has occurred to a deposit insurance fund.

DSC Responses to OIG Recommendations

DSC generally agreed with four of the five recommendations. Although DSC disagreed with Recommendation 3, DSC provided an alternative corrective action that addresses the intent of that recommendation. Accordingly, we consider all five recommendations resolved; however, they will remain undispositioned and open until we can determine that corrective action has been taken and does in fact address our concerns. As one course of action that addresses all of the recommendations, DSC will discuss this report at a senior management meeting with all of its regional directors during the week of March 10, 2003. Detailed below is a summary of each recommendation and DSC and OIG comments pertaining to the recommendation.

Recommendation 1: Include a provision in enforcement actions for certain troubled institutions, that the FDIC receive prior notice of material transactions, out-of-territory lending, or proposed new business activities and be afforded the opportunity to review and comment on same before the institution conducts such transactions or engages in such activities.

DSC agrees with this recommendation. DSC will address this topic during periodic teleconferences that DSC currently has with all regional offices to discuss enforcement actions in process. DSC states that DSC and PCA often require prior notice of "new" business activity; however, our concern is with "material" activity that may be transacted in the area of new or existing business activities, or in situations that may involve insider fraud or other management deficiencies.

Recommendation 2: Revise the *Case Managers Procedures Manual* to ensure that bank management is fully assessed before approving applications for mergers and acquisitions. This should include analyzing all aspects of corporate governance and examining management's past responsiveness to recommendations made in examination reports.

DSC agrees with this recommendation. By September 30, 2003**,** DSC will review its *Case Managers Procedures Manual* to determine whether more guidance is needed regarding the assessment of management during the review of mergers and acquisitions.

Recommendation 3: Regarding capital injections in conjunction with an acquisition, merger, or change of control application, require: (a) acquirers to specify the source of funding in the application package and provide proof the funds are available (this could include requesting tax returns, bank and broker statements, audited financial statements, and any other information deemed necessary to validate the source of funding) and (b) DSC to review and validate the information submitted by acquirers prior to executing the transaction, and document resulting determinations.

DSC considers this recommendation too broad and unnecessary. DSC believes that verifying financial information and the source of funding on every merger application would create undue regulatory burden. According to DSC, it processed 350 merger and change of control applications during 2002 and believes this requirement would be an imprudent use of its resources.

Our recommendation is aimed principally at those mergers or change of control applications that require a capital injection. While we have no specific data available to review, we estimate that capital injections would be required in only a small fraction of mergers and change of control applications. To require less information from an investor trying to purchase an FDIC-insured institution than a typical borrower would be required to submit for a loan at a bank seems fundamentally flawed. In our view, the relatively small amount of time needed to ascertain and validate financial capability far outweighs the risk of repeating what happened at CBC.

However, because DSC indicated that it will consider adding or clarifying guidance to the *Case Managers Procedures Manual* by September 30, 2003, we consider this recommendation resolved.

Recommendation 4: Require field office examiners and regional office staff to fully document the rationale behind the decision-making process related to assigning CRA ratings that are based on special circumstances and not on a bank's actual CRA performance during the period under review. At a minimum, the documentation should include the rationale for assigning the CRA rating, a summary of DSC senior management's discussions with bank management, an explanation of the special circumstances considered, and a planned approach for periodic follow-up visits, offsite monitoring, or periodic reporting by the bank.

DSC indicates that existing guidance issued in 2001 and updated in 2003 addresses this recommendation. As part of the audit resolution process, the OIG will review the updated guidance to determine whether it addresses the intent of this recommendation.

Recommendation 5: Encourage examiners to work collaboratively with state examiners at resolving issues related to state banking laws, particularly when those issues directly affect the safety and soundness of an institution. This would include seeking advice from counsel.

DSC believes that current guidance and the distribution of this report provides staff with sufficient guidance on issues raised in this recommendation. The OIG plans to perform an audit in the area of coordination with state banking supervisors and will further evaluate this issue as part of that review.

Appendix VI contains a summary chart of management's responses to our recommendations.

State of Connecticut Response

On March 7, 2003, the Banking Commissioner for the State of Connecticut provided a written response to the draft report. The response is presented in its entirety as Appendix V to this report. In his response, the Commissioner stated that our review is "reasonably presented" and the recommendations "entirely appropriate." The Commissioner noted in his response that the

State of Connecticut Department of Banking, in considering the merits of CBC's acquisition of MTB Bank, had assessed and received confirmation of the Chairman's intent to use personal financial resources for the $20 million capital injection. It would appear that the State and the FDIC relied on the same information regarding this matter. As discussed in our report, we concluded that more needed to be done to validate the Chairman's intention.

Finally, the Commissioner indicated that the Department has proposed legislation that, if enacted, would address issues raised in this report pertaining to legal lending limits.

APPENDIX I

OBJECTIVES, SCOPE, AND METHODOLOGY

We performed this audit in accordance with section 38(k) of the Federal Deposit Insurance (FDI Act), which provides that if a deposit insurance fund incurs a material loss, with respect to an insured depository institution, on or after July 1, 1993, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. A loss is considered material if it is or becomes apparent that the loss will exceed $25 million and 2 percent of the institution's total assets at the time the Corporation was appointed receiver. The FDI Act requires that the OIG report be completed within 6 months after "it becomes apparent" that a material loss has been incurred. However, the amount of the loss estimate can vary based on changing economic conditions and the FDIC's approach to resolving and liquidating the institution. The actual loss will not be known until all receivership assets are liquidated. As a result, in determining whether to initiate a material loss review, the OIG generally relies on the loss estimates recorded by the FDIC's Division of Finance (DOF). CBC was closed on June 26, 2002 with total assets of about $379 million. On September 10, 2002, DOF provided the OIG with its initial estimated loss of $65 million to the Bank Insurance Fund, and we immediately initiated our material loss review. As of December 31, 2002, the revised estimated loss is $63 million.

The scope of this audit included an analysis of CBC's operations from 1991 until its failure on June 26, 2002. Our review also entailed an evaluation of the regulatory supervision of the bank over the same period. As mandated by the FDI Act, the audit objectives were to: (1) ascertain why the bank's problems resulted in a material loss to the insurance fund and (2) assess the FDIC's supervision of the bank, including implementation of the Prompt Corrective Action (PCA) requirements of section 38 of the FDI Act. To achieve these objectives, we performed the following procedures and techniques:

- Analyzed examination and visitation reports prepared by the FDIC and the State of Connecticut examiners from 1991 until 2002;
- Reviewed bank data and correspondence maintained at the Division of Supervision and Consumer Protection's (DSC) Boston Area Office;
- Reviewed reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure;
- Interviewed DSC management in Washington, D.C., and the Boston Area Office;
- Interviewed DRR officials at the Dallas Regional Office;
- Interviewed FDIC examiners from the Hartford, Connecticut Field Office and Boston Area Office who participated in examinations or reviews of examinations of CBC;
- Met with officials from the State of Connecticut Department of Banking to discuss the historical perspective of the institution, its examinations, state banking laws, and other activities regarding the state's supervision of the bank;
- Researched accounts receivable purchase facilities;
- Reviewed bank records obtained from DRR in Dallas, Texas, for information that would provide insight into the bank's failure;
- Reviewed various annual reports and accompanying financial statements;

- Reviewed pertinent DSC policies and procedures; and
- Researched various banking laws and regulations, including legal lending limits for the State of Connecticut.

We performed the audit fieldwork at the DSC and Legal Division Boston Area Office in Braintree, Massachusetts; the DSC field office in Hartford, Connecticut; DRR offices in Dallas and Carrollton, Texas; the State of Connecticut Department of Banking in Hartford, Connecticut; and DSC offices in Washington, D.C. We conducted the audit from September 2002 through January 2003 in accordance with generally accepted government auditing standards.

Due to the limited nature of the audit objectives, we did not assess DSC's overall internal control structure. We did not test internal controls, review performance management, or test for irregularities or illegal acts, except as noted in this report and concerning the nominee loan scheme. Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act.

We performed a limited review of CBC's management controls pertaining to its operations, to ensure:

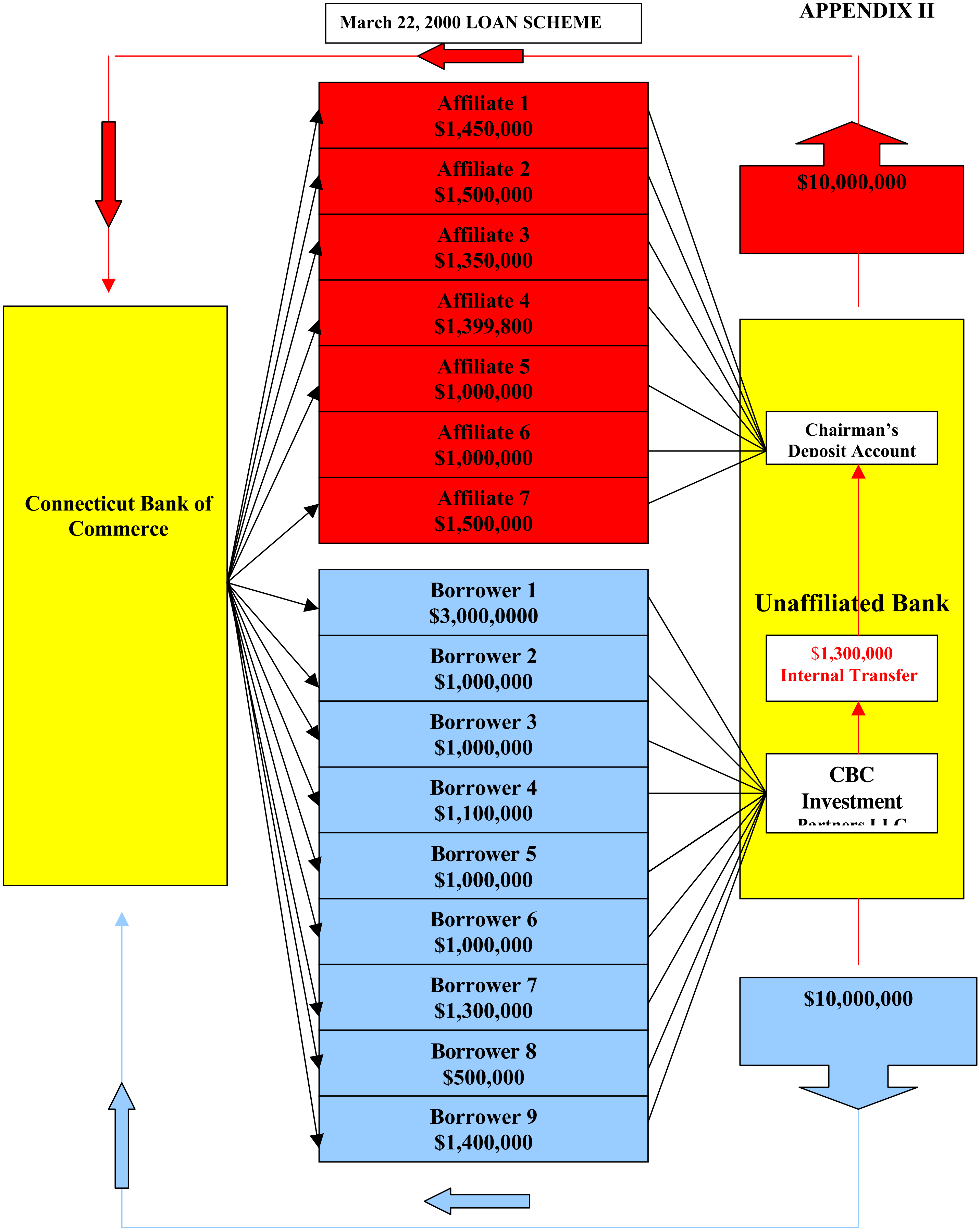
- Programs (lending, risk management, etc.) met objectives;
- Validity with reliability of data is obtained, maintained, and fairly disclosed in reports;
- Compliance with laws and regulations; and
- Safeguarding resources against waste, loss, and misuse.

We reviewed documentation and conducted inquiries regarding CBC's illegal acts or abuses that were identified by FDIC.

We did not assess the validity and reliability of computer-based and processed data from CBC or the FDIC because this was not an objective of the audit. We relied upon interviews and individually prepared reports and correspondence and other evidence to support our audit. Therefore, the audit results were not impacted.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, manage and measure results to justify appropriations and authorizations, and design budgets that reflect strategic missions. In this audit, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives.

APPENDIX II



Source: Division of Supervision and Consumer Protection, Hartford Field Office

APPENDIX III

CHRONOLOGY OF SIGNIFICANT EVENTS

The following chronology describes significant events in CBC's history, including: examinations conducted, major problems identified, and enforcement actions taken by the FDIC and the State of Connecticut Department of Banking.

7/23/64	Bank is established as The Woodbridge Bank and Trust Company and becomes FDIC-insured.
3/15/78	The bank's name is changed to Amity Bank Corp.
8/10/90	FDIC examination resulted in a CAMEL "4" rating.
7/9/91	Bank management stipulated to a Cease and Desist (C&D) Order regarding bank operations. The Order was issued to address the unsatisfactory conditions disclosed during the August 10, 1990 FDIC examination. The provisions required qualified management, sufficient reserve for loan losses, minimum level of Tier 1 Capital, a plan to reduce classified assets, improved documentation of Board meeting minutes, revised loan policy, establishment of a profit plan to improve earnings, regulator approval of dividends, and correction of violations.
12/16/91	FDIC and Connecticut Department of Banking (State) examination resulted in a CAMEL and Composite rating of 5-5-3-5-3/5.
2/29/92	With Amity Bank on the verge of failure, a private investor acquired approximately 80 percent ownership interest in the bank for $5 million. Bank assets total approximately $151 million. The private investor becomes Chairman of the Board of Directors. He brings in a new president, chief financial officer, and Board of Directors.
1/11/93	The bank's name was changed to Connecticut Bank of Commerce.

9/13/93	FDIC examination resulted in a CAMEL and Composite rating of 5-5-4-5-3/5. Failure was inevitable absent a substantial and immediate infusion of capital. CBC was placed in a 90-day Prompt Corrective Action (PCA) resolution status with an expected bank closing date of March 4, 1994. A "critically undercapitalized" PCA category is reflected. Total assets are $140 million.
10/93	Two bank presidents were hired and resigned within the preceding 8 months. One president stated that the Chairman impeded his efforts to operate the bank.
11/18/93	New president announced as Chief Executive Officer and Director.
12/16/93	Bank management stipulated to a second C&D Order regarding management performance. The provisions required a revised conflict of interest policy, a study/audit of institution-affiliated parties, establishment and retention of qualified management, and correction of all violations.
3/24/94	The Chairman injected approximately $5.5 million averting bank closure.
7/25/94	FDIC examination resulted in a CAMEL and Composite rating of 5-5-3-5-3/5. CBC enters into a new business, a lease-financing program, assisted by a new affiliate, EQ Corporation. This program provided a needed increase in earnings but the risk was high. Total assets are $104 million.
9/25/95	FDIC examination resulted in a CAMEL and Composite rating of 5-5-3-5-3/5. Asset quality remained the largest detriment to improvement in overall condition. Total assets are $84 million.
10/15/95	An additional $400,000 in capital received from the Chairman. A "significantly undercapitalized" PCA category is reflected.

4/15/96	A State examination resulted in a CAMEL and Composite rating of 5-5-3-5-3/5. Concentrations of Credit to Tier 1 Capital is significantly high at 434 percent. Lease financing through EQ Corporation represents a 247 percent concentration. The president of 3 years resigned. The State noted that he cited personal reasons for his resignation. State believes it was due to frustration over the Chairman not putting enough capital into the bank to enable him to sell off the non-performing assets and take the bank in the direction he wanted it to go. New president joins bank 2 months later.
8/1/96	New Executive Vice President and Chief Lending Officer joins the bank.
12/30/96	FDIC examination resulted in an improved CAMEL and Composite rating of 4-4-3-5-2/4. Capital levels benefited from a capital infusion of privately owned stock, valued at $2,420,000, contributed by the Chairman. Capital levels achieved regulatory guidelines but not in compliance with the C&D Order. An "adequately capitalized" PCA category reflects improvement. Management stresses community banking; however, most new activities are conducted outside of the local area, leading examiners to question management's long-term goals and the direction of the bank. Both C&D Orders remain outstanding despite objections from bank for release in light of improved capital status. Total assets are $82 million.
9/30/97	The bank's audited financial statements reflect the residual value of its interest in four Boeing 727 cargo aircraft at $4.5 million.
10/20/97	Concurrent FDIC and State examination assigned a CAMELS and Composite rating of 3-4-3-4-3-2/4. The bank began a new business in the form of out-of-area Accounts Receivable Financing. This program was not addressed in the bank's loan policy and constituted 259 percent of the bank's equity capital and reserves. A number of these loans appeared to exceed Connecticut legal lending limits. An "adequately capitalized" PCA capital category remains.
9/3/98	Executive Vice President and Chief Lending Officer promoted to Chief Operating Officer.

10/26/98	Concurrent FDIC and State examination resulted in a CAMELS and Composite rating of 3-4-3-3-2-2/3. Modest improvement in overall condition. An "adequately capitalized" PCA capital category remains. Insufficient monitoring system for Accounts Receivable Financing remains. Adversely classified assets in the Accounts Receivable Financing area are high.
3/23/99	Memorandum of Understanding (MOU) replaced the two outstanding C&Ds. The MOU mainly focused on improving asset quality. Additionally, a capital restoration plan called for a specific capital level higher than PCA requirement; annual review of conflicts of interest policy; retention of qualified management; informing regulators of consideration of new lines of business; development of policies and procedures for new business; regulator approval of new business; and prior approval of the Board before executing new business.
4/23/99	CBC entered into a Purchase and Assumption agreement to purchase substantially all of the $250 million assets and assume the deposits and certain liabilities of MTB Bank.
8/4/99	CBC filed an application with the FDIC to acquire MTB Bank. The application provided that concurrent with the merger, the Chairman of the Board would inject $20 million into the bank.
8/30/99	FDIC Community Reinvestment Act (CRA) examination revealed that the bank's niche of focusing on lease finance receivables led to lending outside of the bank's assessment areas. Examiners initially recommended a "Needs to Improve," rating; however, after much discussion between bank management, FDIC, and State officials, the rating was changed to "Satisfactory," based on performance context as stated in FDIC Regulation 345.21(b). The FDIC recommended a Board Resolution to ensure necessary efforts would be made to improve the bank's CRA performance. CBC's Board of Directors adopted the resolution.
10/20/99	The Board of Directors approved a $1.7 million investment in foreign currency futures options without ensuring that management performed sufficient due diligence.

12/27/99	Joint FDIC and State examination resulted in a CAMELS rating of 2-3-3-3-2-2/3. Management took steps to meet the provisions of the MOU but the volume of adverse classifications needed to be reduced. Eight relationships of concentrations of credit represented 491 percent of Tier 1 Capital. Total assets of the bank were $99 million.
2/25/00	The FDIC approved the Purchase and Assumption transaction to acquire MTB Bank.
3/22-29/00	At the direction of the Chairman, the bank funded approximately $20 million in loans when in the prior 2 months, loans averaged less than $5 million each month. Examiners discovered later that the proceeds of these loans were used to fund the acquisition of MTB Bank.
3/31/00	Acquisition of MTB Bank occurred.
6/00	Board of Directors approved over $11 million in loans to entities controlled by the Chairman, his children, and/or his business associates. Most of these loans were used to purchase non-performing loans from the bank, giving the appearance that a third party was buying the loans without financing from the bank.
9/11/00	Joint FDIC and State visitation to assess the bank's progress with the purchase of assets and assumption of liabilities of MTB Bank. Integration of the two institutions remained a work in progress.
3/5/01	A joint FDIC and State examination revealed that inadequate Board and senior management oversight contributed to the deterioration of the bank's overall condition. CAMELS and Composite rating is 3-4-4-3-3-3/4. A "well capitalized" PCA capital category shows improvement. Examiners question suspicious and unusual loan activity that took place the week before the merger with MTB Bank.
6/21/01	A 10(c) investigation began to research whether there was evidence of the Chairman orchestrating the transactions to obtain some or all of the $20 million capital injection required as a condition of the merger.

12/10/01	C&D Order took effect outlining the significant deficiencies that needed to be corrected and addressed from the March 5, 2001 examination. Such deficiencies included credit underwriting and loan administration weaknesses; inappropriate risk rating for the allowance of loan losses; unrealistic budget and strategic plan; and apparent violations. Management and the Board of Directors failed to fully address the majority of the Order provisions.
2/8/02	Arthur Andersen, LLP expressed an unqualified opinion on the financial statements as of December 31, 2001 and 2000.
4/01/02	A joint FDIC and State examination began as of April 1, 2002. The bank was closed before the examination report was finalized. Tangible equity capital to total assets after adjusting for preliminary results of the examination showed negative capital levels. A "critically undercapitalized" PCA capital category reflects a downgrade.
6/23/02	At a special Sunday night meeting, the Board of Directors approved $16,796,082 in loans. The Monday after the board meeting, $12,677,894 was wired to various institutions.
6/25/02	The FDIC determined that the continued employment of the Chairman and President would not materially strengthen the Bank's ability to become adequately capitalized. Prompt Corrective Action Directive ordering dismissal of the Chairman and President issued.
6/26/02	The Commissioner of the Connecticut Department of Banking ordered CBC closed and appointed the FDIC as receiver.
6/28/02	The FDIC as receiver is able to recover payments made on $11.5 million of the "Sunday night" loans.

CORPORATION COMMENTS

FDIC

Federal Deposit Insurance Corporation
550 17th St. NW Washington DC, 20429 Division of Supervision and Consumer Protection

March 6, 2003

TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Michael J. Zamorski *Michael J. Zamorski*
Director, Division of Supervision and Consumer Protection

CONCUR: John F. Bovenzi
Deputy to the Chairman and Chief Operating Officer

SUBJECT: Draft Report Entitled *Material Loss Review of the Failure of the Connecticut Bank of Commerce, Stamford, CT*

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Connecticut Bank of Commerce (CBC), Stamford, Connecticut, which failed on June 26, 2002. This memorandum represents the Division of Supervision and Consumer Protection's (DSC) response to the OIG's Draft Report dated February 26, 2003 and received March 4, 2003. While we believe the opportunity to respond to a Draft Report is absolutely necessary, procedurally we have concerns in responding to a Draft Report that continues to undergo changes. This presents the possibility that our response may not be completely germane to comments appearing in the Final Report.

SUMMARY RESPONSE

Our supervisory process is intended to prevent problem situations from remaining uncorrected and deteriorating to a point that results in loss to the FDIC. With the benefit of hindsight, we can point to certain decisions that, if handled differently, may have changed the outcome in this case. However, based on the information available at the time, DSC's supervision of CBC was appropriate. In addition, due to the massive fraud perpetrated by insiders and the directors' dereliction of their duties, CBC's eventual failure would have been very difficult to prevent.

DSC disagrees with some of the OIG's findings regarding our supervision of CBC. Foremost, we disagree with OIG's conclusion that, "CBC failed and resulted in a material loss to the Bank Insurance Fund because of ineffective corporate governance." CBC's ineffective corporate governance left its officers unchecked and allowed dubious insider activities to go undetected; however, the proximate cause of CBC's failure was insider fraud in the form of nominee loans totaling at least $34 million. Proper internal controls can reduce the likelihood of fraud; however, even the most effective system of corporate governance cannot prevent all fraud, in particular cases involving the collusion of senior management and their related interests.
The Draft Report includes five formal recommendations intended to help prevent similar events in the future. While DSC agrees fundamentally with four of the five recommendations, we believe our existing policies and practices sufficiently address the underlying issues.

DISCLOSURE AND PRIVILEGE ISSUES

On November 22, 2002, the FDIC issued a Notice of Charges against the Chairman, the President, and six outside directors of CBC. The FDIC is seeking civil money penalties against all respondents, prohibition of the Chairman and the President from further participation in the banking industry, and restitution from the Chairman and the President for the outstanding balance of the nominee loans. The case is now in the discovery stage, and a tentative hearing date has been set for November 17, 2003. In addition, the FDIC is involved in litigation in U.S. District Court in Washington, D.C. arising from an immediate asset freeze issued by the FDIC against the Chairman and the President with the Notice of Charges. Consequently, we have some concerns about disclosure of privileged and/or pre-decisional information.

CAUSE OF FAILURE AND MATERIAL LOSS

The Draft Report concludes, "CBC failed and resulted in a material loss to the Bank Insurance Fund because of ineffective corporate governance." DSC concurs with the OIG's description of CBC's ineffective corporate governance; however, we disagree that it caused the failure and resulted in the material loss to the FDIC. Ineffective corporate governance resulted in excessive risk taking, disregard for laws and regulations, and questionable asset valuations – all of which exacerbated the potential loss to the FDIC. High-risk lending combined with poor risk management practices caused significant losses for CBC prior to failure and has resulted in deep discounts on assets sold by the FDIC. As receiver, the FDIC has also realized significant losses on the liquidation of certain other assets. However, the largest contributing factor to CBC's failure and the material loss to the FDIC was fraud perpetrated by insiders of the bank.

On March 31, 2002, CBC reported equity capital of $29.6 million. DSC has identified nominee loans involving the Chairman and the President with an aggregate outstanding balance of approximately $34 million, and additional fraudulent loans may have been passed to the receivership without being identified. A majority of the nominee loans were classified as Loss at the final examination of CBC, and the Division of Resolutions and Receiverships expects minimal collections from any of the nominee loans. Fraud was clearly the proximate cause of CBC's failure. The magnitude of the fraud also limited the effectiveness of the Prompt Corrective Action (PCA) provisions of Section 38 of the FDI Act.[1]

SCOPE OF FRAUD INVESTIGATION

The OIG's comments throughout the Draft Report do not accurately depict the complexity of the nominee loan schemes at CBC or the scope of the investigation necessary to fully uncover the magnitude of the fraud. For example, the Draft Report states, "Examiners did not determine the true financial condition of CBC until they investigated the matter after the March 2001 examination, when they uncovered the loan schemes and determined the bank was critically undercapitalized." During the March 2001 examination, the examiners noted an unusually high volume of loans originated in the last week of March 2000. The inordinate volume, generic

[1] The FDIC has noted previously that PCA does not provide much protection to the deposit insurance funds when rapid dissipation of assets and capital occurs at an institution.

purpose statements, lack of documentation, connections to the Chairman, and the timing of these loans raised serious concerns that were relayed to DSC senior management and the Legal Division. However, it was during a lengthy investigation authorized under Section 10(c) of the FDI Act that we determined that the suspicious loans were part of a nominee loan scheme used by the Chairman to fund the purchase of MTB Bank, New York, New York.

The investigation commenced on June 21, 2001, and required the deposition of 22 individuals (directors, officers, and borrowers) and the subpoena of records from borrowers, an investment partnership, and unaffiliated banks. Half of the fraudulent $20 million capital injection was channeled through the Chairman's name, and half went through a limited liability company formed solely to facilitate the fraud. It was necessary to trace the proceeds from CBC into the nominee borrowers' accounts at unaffiliated banks, into the Chairman's or the limited liability company's accounts at an unaffiliated bank, and back into accounts at CBC.

Eight of the fifteen nominee borrowers related to the March 2000 loan scheme had prior lending relationships with CBC. We had to determine which portion of these relationships was legitimate and what amount was redirected for the Chairman's ulterior motives. For example, on March 22, 2000, CBC increased a certain hospital's accounts receivable purchase facility from approximately $1 million to $3 million. Then, even though the hospital only had qualifying accounts receivable of approximately $1.4 million, CBC advanced $1.5 million on the facility on March 24, 2000 bringing the total outstanding to approximately $2.5 million. CBC also granted the hospital a $1.5 million term note on March 24, 2000 for working capital. The investigation revealed that $3 million of the new funds were improperly redirected to the limited liability company and used to purchase stock in CBC.

In addition, the investigation uncovered other suspicious loans that required significant examination. Many of these credits were determined to be nominee loans to refinance certain nonperforming loans, keep other nominee loans current or pay them off, and to improperly provide funds to the Chairman and his related entities.

INTEREST IN CARGO PLANES

During 1996, CBC acquired a senior interest in a collateral pool from a subsidiary of an unaffiliated leasing company. The collateral consisted primarily of four Boeing 727 cargo planes. The investment was structured as an amortizing loan which would be repaid from the leases on the planes, and the loan generally performed as agreed. A junior position in this same collateral pool was acquired by CBC in 1997 as additional collateral for a related medical equipment leasing facility. When the prior liens were paid and the planes came off lease, the planes would be sold and CBC would receive payment on their subordinated interest.

The Draft Report states, "For example, questionable valuations regarding CBC's interest in the four cargo planes were not adequately addressed in financial statements from 1997 until CBC failed. As a result, CBC's capital was overstated every year in its financial statements from 1997 until CBC failed." The Draft Report also states, "According to DRR officials, it appears these planes were sold in 2001 for approximately $2.5 million, and the bank received nothing from the sale of the planes." The Draft Report concludes, "The value of this interest ranged from

$4 million to $5.2 million during that period. In actuality, the value of these cargo planes was significantly less, but the bank was able to hide that fact from examiners. Had the $4.5 million been deducted from CBC's capital account, the bank would have had a PCA capital category of 'critically undercapitalized' from 1997 forward and would have been prevented from acquiring MTB Bank due to the capital deficiency."

DSC believes the OIG's conclusion regarding CBC's interest in the cargo planes is unfounded. The OIG apparently assumes that if CBC or the FDIC as receiver eventually received nothing from the sale of the planes that the asset never had value and should have been charged off in 1997. In reality, asset values fluctuate and residual interests are generally much more volatile than the value of the underlying asset. The OIG can not impeach the historical value of the cargo planes based on subsequent events. More specifically, it is not fair to assume that the asset had no value in 1997 (and forward) based on events in 2001 and/or 2002.

The Draft Report also states, "Because this asset represented 68 percent of the bank's equity capital in 1997, we believe this transaction warranted more in-depth review." CBC's relationship with this unaffiliated leasing company was reviewed closely at every applicable examination and listed as a concentration since 1994. The concentration totaled $17 million at the March 2001 examination and consisted of CBC's senior and subordinated interests in the cargo planes, a $6 million accounts receivable purchase facility, a term loan to an Equilease subsidiary, and four revolving lines of credit to purchase leases. At the 1996 examination, CBC's interest in the four cargo planes was reviewed by a senior FDIC examiner and capital markets specialist. (This examiner was not interviewed by the OIG.) The examiner concluded that there were no credit or administrative weaknesses associated with the transaction.

During the 2002 examination, management produced an April 15, 2002 letter from the subsidiary of the unaffiliated leasing company stating that CBC could expect to receive $5.2 million in May and August 2002. This letter conflicts with the information subsequently discovered by the Division of Resolutions and Receiverships, and there is an ongoing fraud investigation related to this asset.

ACQUISITION OF MTB BANK

On February 25, 2000, DSC approved CBC's application to acquire MTB Bank. The Draft Report states, "The FDIC did not fully consider the past performance of bank management before approving the application to acquire MTB Bank. The bank had a history of poor management, risky lending, insufficient loan administration, concentrations of credit risk, and questionable compliance with banking laws. These deficiencies were not addressed in the analysis of the application. In total, these management deficiencies raise doubts regarding the FDIC's decision to approve CBC's application to acquire MTB Bank."

Cognizant of our previous criticisms of CBC management, DSC took extra care in processing the application to acquire MTB Bank. A May 27, 1999 file memorandum documents our apprehension as early as the first meeting with CBC officials to discuss the acquisition, "Regional Director Rohan pointed out the difficulty we would have in approving the merger of two 'troubled' banks, particularly since we continue to remain somewhat uncomfortable with

CBC's risk profile despite the recent exam upgrade." Our analysis related to the application acknowledges that CBC management had been rated "3" or "4" since 1990 and that the Chairman and principal shareholder continued to be the dominant force behind the bank's direction. However, during the 1998 and 1999 examinations, we saw an increased effort by management to adhere to regulatory recommendations and implement corrective actions. The December 27, 1999 Report of Examination included the following comments:

- Management has taken appropriate steps to address regulatory concerns.
- Management has actively taken steps to meet the provisions of the Memorandum of Understanding (MOU).
- Management has implemented procedures to strengthen loan administration; however, additional efforts to correct deficiencies are necessary.
- The Loan, Accounts Receivable Purchase, and Leasing Policies are generally adequate with some enhancements recommended.
- Underwriting practices are satisfactory, and internal risk ratings are appropriately assigned with some exceptions noted.
- Operating management and the directorate continue to take appropriate steps to address regulatory concerns, as evidenced by the compliance efforts relative to the outstanding MOU.
- The aforementioned improvement in overall asset quality is reflective of management's efforts to both improve the risk profile and effect repayment of troubled credits.

In addition, the bank's condition was also improving, due in large part to actions taken by management. CBC's Tier 1 leverage ratio increased from 5.36 percent on December 31, 1996 to 8.52 percent on December 31, 1999. CBC's 1999 return on assets of 1.36 percent compared very favorably to the negative 1.17 percent in 1996. Non-current loans were also down from 6.49 percent on December 31, 1996 to 2.87 percent on December 31, 1999. Adversely classified assets as a percentage of capital and reserves had declined from 126 percent at the 1996 examination to 30 percent at the 1999 examination.

DSC conducted an extensive analysis of the proposed management team of the resultant bank. Under the proposal, CBC would obtain three additional outside directors from MTB, six senior officers from MTB, and three completely new senior officers to be hired due to the acquisition. The addition of three outside directors and nine senior officers was viewed favorably, and many of the officers would fill positions in areas where deficiencies remained.

DSC clearly had concerns regarding the prior history of poor management at CBC. However, we determined that the improvement in management's responsiveness and the potential to add many new qualified members to the management team outweighed our reservations regarding CBC's past regulatory troubles.

ENFORCEMENT ACTIONS

The Draft Report states, "The FDIC agreed to remove two C&D enforcement actions in March 1999 even though the bank was not in full compliance with the actions. The C&D orders were replaced with an informal MOU despite the fact that the bank remained deficient in its risk management and risk diversification practices, loan administration, and asset quality." Later, the

Draft Report concludes, "While we have concerns about the lifting of the C&D orders in 1999, we are not making any formal recommendations at this time related to that issue. The OIG plans on doing future audit work on a national level that will address the process used by DSC to determine when enforcement actions are lifted."

Despite the lack of a formal recommendation, DSC is compelled to address the lifting of the C&D orders in 1999. While CBC may not have been in compliance with every provision of the orders, management's efforts to comply with the enforcement actions had improved considerably. The orders were issued in 1991 and 1993, and many of the provisions were no longer applicable as CBC's business activities had changed. It is unusual for a C&D order to remain outstanding for more than two or three years. In this case, not only did many of the provisions no longer apply, but the orders also did not address the new activities and deficiencies that DSC was most concerned with in 1999. Given management's better efforts to adhere to regulatory recommendations at that time, the bank's improving financial condition, the bank's "3" Composite rating, and management's willingness to sign the MOU, DSC did not pursue replacing the orders with a formal enforcement action. Therefore, DSC replaced the orders with a detailed MOU that addressed our concerns at CBC at that time, such as concentrations, and actually raised the capital requirement from 6 percent to 7.5 percent.

EXAMINER CONCERNS IGNORED

The Draft Report states, "The Bank's Board of Directors and senior management frequently ignored or did not fully address examiner concerns. Examination reports from 1996 through 2001 identified recurring problems at the bank that required attention." While certain recommendations were repeated at several examinations, CBC's Board and senior management did not necessarily ignore all examiner concerns from 1996 through 2001. Management attempted to address our concerns in certain areas, but while their actions were positive, we were not fully satisfied and certain criticisms were repeated. Other times, management implemented some specific recommendations fully but new deficiencies would be found in other areas. Also, as discussed previously, the 1998 and 1999 examinations noted marked improvement in management's efforts to address regulatory issues and the outstanding enforcement actions.

COMMUNITY REINVESTMENT ACT RATING

CBC's Community Reinvestment Act (CRA) rating did not contribute to the bank's failure or the material loss to the FDIC and would appear to be outside the scope of the material loss review. However, the OIG analyzed CBC's 1999 CRA rating as it related to DSC's decision to approve the acquisition of MTB Bank. The Draft Report concludes, "Based on our review of CRA workpapers and follow-up discussions with the Examiner-In-Charge and the Review Examiner, we did not find convincing evidence to support the 'Satisfactory' CRA rating assigned. The rating appears to be based solely on the bank's projected performance and not on its actual performance during the time period under review."

We do not agree that CBC's rating was based solely on projected performance as opposed to the bank's actual performance. Throughout the evaluation, where appropriate, the examiner explains that lower levels or distributions of lending activity in the assessment area, which normally depict less than Satisfactory performance, resulted from the need for the bank to respond to safety and soundness enforcement actions. The performance context factors in the CRA regulation explicitly include consideration of an institution's capacity and constraints when evaluating lending performance. Financial institutions that are constrained from lending due to safety and soundness reasons should not automatically receive a less than Satisfactory rating.

The examiner's evaluation discusses the impact of such constraints on CBC's CRA lending performance. The bank was required to improve capital levels and profitability and to establish prudent lending limits. The examiner writes in the evaluation that "lending efforts were hampered by a large portfolio of non-performing loans, poor earnings, regulatory enforcement actions and a reduction in personnel." The examiner appropriately notes that after a long period of cutbacks, the bank only recently was able to increase staff and undertake efforts to improve lending levels, results of which were yet to be seen. Additionally, the examiner references the business strategy of the bank, another performance context consideration within the regulation, to explain low levels of lending in some product lines. The rationale for the rating is sound.

Regarding CBC's acquisition of MTB Bank, it is important to note that each institution's CRA rating is one element to consider when evaluating the factor of *Convenience and Needs of the Community to be Served* under Section 18(c) of the FDI Act. MTB Bank had a CRA rating of "Outstanding" as of January 28, 1999. Other factors to consider include the extent to which the proposed merger is likely to improve the service to the general public through such capabilities as higher lending limits, new or expanded services, reduced prices, or increased convenience in utilizing the services and facilities of the resulting institution. The analysis of the proposed merger included all of these factors. DSC determined that the merger was expected to have a positive effect on the ability of CBC to meet the convenience and needs of the community as a result of the increased capital levels, anticipated improvement in earnings, and additional management expertise provided by MTB Bank.

RESPONSES TO FORMAL RECOMMENDATIONS

The OIG's Draft Report includes five formal recommendations intended to help improve the bank supervision process and to promote the safety and soundness of FDIC-regulated institutions. DSC fundamentally agrees with four of the recommendations, but we note that our existing practices, policies, and procedures already satisfactorily address the underlying issues. DSC believes recommendation three would create an unnecessary burden on the industry, infringe on the discretion of the Division, and add no value to the supervisory process.

1. **Include a provision in enforcement actions for certain troubled institutions, that the FDIC receive prior notice of material transactions, out of territory lending, or proposed new business activities and be afforded the opportunity to review and comment on same before the institution conducts such transactions or engages in such activities.**

For troubled institutions, DSC considers all types of enforcement action provisions that could assist in correcting the unsafe or unsound practices or conditions identified at the institution. We often include a provision that the FDIC receive prior notice of any new business activity – in fact, that provision was included in the March 1999 Memorandum of Understanding and the December 2001 Cease and Desist Order issued against CBC. There have been many instances where our enforcement actions restrict or even prevent further out of territory lending, and that type of restriction may have been appropriate in this case. Our enforcement action tools are intended to be flexible, and DSC's practice is to tailor the provisions to the problems identified at the institution. For example, we recently used a provision that required prior notice to the FDIC of any affiliate transactions. In certain situations, we have considered requiring prior notice of all material transactions. However, DSC and the Legal Division have attempted to strike a balance between restricting a bank's activities and avoiding the appearance of managing the bank's operations.

<u>DSC's planned course of action:</u>
The Prompt Corrective Action provisions of Section 38 of the FDI Act automatically require Critically Undercapitalized institutions to provide prior notice of any material transactions to the appropriate Federal regulator. Congress decided that this restriction should only apply in the most critical situations. However, regardless of a bank's capital category, DSC will continue to consider requiring prior notice of all material transactions when it is deemed necessary and beneficial. This topic will be addressed during the periodic teleconferences we currently have with each regional office to discuss enforcement actions in process. The Draft Report and our response will also be discussed at the DSC senior management meeting next week with all of our regional directors.

2. **Revise the *Case Managers Procedures Manual* to ensure that bank management is fully assessed before approving applications for mergers and acquisitions. This should include analyzing all aspects of corporate governance and examining management's past responsiveness to recommendations made in examination reports.**

As previously discussed in this response, DSC disagrees with the implication of this recommendation that bank management was not fully assessed before approving CBC's acquisition of MTB Bank. Because of the history of supervisory concerns with CBC management, we were extra cautious in our evaluation of the managerial resources (from CBC and MTB Bank) that would be available after the proposed merger. We clearly had concerns with certain aspects of the CBC management team; however, the two most recent examinations had noted an improved effort on management's part to implement regulatory recommendations and to adhere to the outstanding enforcement actions. In the end, DSC determined that the noted recent improvement in CBC management's responsiveness and the potential for adding new qualified members to the management team outweighed our concerns regarding CBC's past regulatory troubles.

<u>DSC's planned course of action:</u>
By September 30, 2003, DSC will review the *Case Managers Procedures Manual* to determine if more guidance regarding the assessment of management during the review of mergers and acquisitions should be added. However, we note that the section of the *Case Managers Procedures Manual* devoted to merger applications references the *Manual of Examination Policies* and the *FDIC Statement of Policy on Bank Merger Transactions* – sources quoted in the

OIG Report for providing detailed guidance on assessing management. The *Case Managers Procedures Manual* is not intended to restate instructions provided elsewhere.

3. Regarding capital injections in conjunction with an acquisition, merger, or change of control application, require: (a) acquirers to specify the source of funding in the application package and provide proof the funds are available (this could include requesting tax returns, bank and broker statements, audited financial statements, and any other information deemed necessary to validate the source of funding) and (b) DSC to review and validate the information submitted by acquirers prior to executing the transaction, and document resulting determinations.

DSC believes this recommendation is too broad and unnecessary. The *Interagency Bank Merger Act Application* adopted by the four Federal banking agencies in January 1999 addresses capital injections in conjunction with mergers. The first item on the interagency application states, "Describe the transaction's purpose, structure, significant terms and conditions, and financing arrangements, including any plan to raise additional equity or incur debt." The application also requires pro forma financial statements that depict any changes to the capital accounts as well as a description of each component of Tier 1 and Tier 2 Capital. The general instructions for the form state, "All questions must be answered with complete and accurate information that is subject to verification."

Outstanding guidance already requires DSC personnel to review all information submitted by a merger applicant. Requiring verification of financial information and the source of funding on every merger application and change of control notice would create an undue regulatory burden on the industry and would be an imprudent use of DSC's resources. The existing application already requires that information be submitted regarding the source of any additional equity and leaves verification to the discretion of the banking agency. During 2002, DSC processed 350 merger applications and change of control notices. On a case-by-case basis, we request additional information, and we take the necessary steps to validate that information depending on the circumstances surrounding the specific application or notice. In certain cases (primarily related to the acquisition of a failing bank or when dealing with unknown entities that are new to the banking industry), DSC requires that the funds be placed in an escrow or deposit account at a third-party institution.

In the CBC case, we requested a financial statement to confirm the controlling owner's ability to provide an additional $20 million in capital. Due to his past sizeable contributions of cash and other liquid assets to the bank and the significant assets reported on his financial statement, we had no reason to question his financial wherewithal or the integrity of the information provided. Therefore, DSC did not require independent verification of the financial statement. Validating the controlling owner's financial statement in this case would not have changed our decision to approve the merger application. Publicly available SEC filings confirm that the controlling owner continued to own, as of November 24, 1999, $31 million of the stock he reported as the largest asset on his financial statement – even after selling over $20 million of the stock in 1999. In addition, validation of the controlling owner's financial statement would likely not have changed his decision to use nominee loans to fraudulently fund the capital injection.

DSC's planned course of action:
During our review of the *Case Managers Procedures Manual*, DSC will consider adding or clarifying the guidance related to the review and/or validation of funding sources in connection with mergers and change of control notices. The Draft Report and our response will be discussed at the DSC senior management meeting next week with all of our regional directors.

4. **Require field office examiners and regional office staff to fully document the rationale behind the decision-making process related to assigning CRA ratings that are based on special circumstances and not on a bank's actual CRA performance during the period under review. At a minimum, the documentation should include the rationale for assigning the CRA rating, a summary of DSC senior management's discussions with bank management, an explanation of the special circumstances considered, and a planned approach for periodic follow-up visits, offsite monitoring, or periodic reporting by the bank.**

As previously discussed, the examiners and regional office staff did document the rationale behind the decision-making process related to CBC's 1999 CRA rating. Nevertheless, DSC has taken steps over the past three years to address this recommendation and believes its actions are responsive to the issues raised by the OIG. Several considerations support our view.

In 2000, the former Division of Compliance and Consumer Affairs (DCA) conducted a formal review of CRA Public Performance Evaluations issued in 1999 and 2000. A subsequent OIG review of the CRA examination process reached conclusions similar to those in the DCA review. Both reviews resulted in swift corrective actions. One of the issues concerned documenting an appropriate rationale for a CRA rating, similar to the OIG recommendation in this case. The Division addressed this and other issues during its national examiner training conference in December 2000 (which was attended by OIG staff), during periodic CRA Public Performance Evaluation quality reviews conducted by regional offices since that time, and in new Summary CRA Guidance issued to examiners in 2001 and updated in 2003.

Meetings and discussions with bank management are typically documented in summary memoranda, notes, and files. The examination of financial institutions with less than satisfactory CRA ratings is accelerated to a 12-18 month cycle. In most cases, this timeframe is sufficient to ensure timely monitoring of a bank's performance. In other cases, depending on any unusual circumstances, the Division has requested periodic reporting from institutions and has conducted interim visitations.

DSC's planned course of action:
While the recommendation is sound in and of itself, DSC believes the recommendation reflects standard, longstanding examination practices within the Division. We will provide the OIG a copy of the CRA guidance issued to examiners in 2001 and updated in 2003. The Draft Report and our response will be discussed at the DSC senior management meeting next week with all of our regional directors.

5. **Encourage examiners to work collaboratively with state examiners at resolving issues related to state banking laws, particularly when those issues directly affect the safety and soundness of an institution. This would include seeking advice from counsel.**

DSC examiners already work collaboratively with state examiners at resolving issues related to state banking laws. The FDIC has entered into agreements with each state and the Conference of State Bank Supervisors regarding the coordination and cooperation between the FDIC and state banking agencies. The agreements have fostered excellent relationships between the FDIC and the states by clarifying examination guidelines, information sharing arrangements, and enforcement action and application processing standards. This positive relationship extends to FDIC and state examiners who often work together on examinations. The last five examinations of CBC were either conducted jointly or concurrently with the Connecticut Banking Department. The examinations were completed efficiently and effectively with no disagreements regarding ratings or supervisory issues.

Beginning in 1996, CBC began offering a new method of financing accounts receivable. CBC asserted that its accounts receivable purchase facilities were not loans but rather the purchase of the individual accounts receivable. CBC contended that since the bank was purchasing the underlying accounts receivable the aggregate amount with one company would not be subject to Connecticut's legal lending limit. Working together, both FDIC and state examiners concluded during the 1997 concurrent examination that CBC's accounts receivable purchase facilities represented direct loans to the companies subject to the legal lending limit rather than actual accounts receivable purchased by the bank. CBC's legal counsel provided a written opinion to the contrary. The Connecticut Banking Department determined that the transactions, as purchases of receivables, would likely be legal under existing Connecticut law. Given that the issue surrounded a state law, DSC deferred to the Connecticut Banking Department and did not continue to cite the violation. However, FDIC and state examiners continued to aggregate the accounts receivable purchase facilities of each company for purposes of citing concentrations.

Regarding CBC's efforts to circumvent the Connecticut lending limit by originating loans to different legal entities involved in the same operation, FDIC and state examiners did collaborate effectively on the issue. During the 2002 examination when this issue became substantive, FDIC and state examiners sought guidance from their respective legal departments. The FDIC's Legal Division reviewed the issue and, after consultation with the attorneys at the Connecticut Banking Department, determined that the loans would not violate the Connecticut lending limit due to the technical nature of the statute and the lack of any legal precedent supporting a broader interpretation of the law. While not citable as a violation, examiners reported these types of relationships as concentrations. This case highlights good coordination between FDIC and state examiners regarding issues related to state banking laws, including seeking advice from DSC management, the FDIC Legal Division, and the state banking department.

<u>DSC's planned course of action:</u>
DSC believes that current guidance and the distribution of the OIG Report provides FDIC staff with sufficient direction and emphasis on the issues raised in this recommendation. The Draft Report and our response will be discussed at the DSC senior management meeting next week

with all of our regional directors. Additionally, DSC's strong working relationships with the various state banking departments provides assurance that important issues will continue to be effectively addressed.

CONCLUSION

We recognize that CBC's failure affords an opportunity to learn and strengthen our supervisory process. However, due to the massive fraud and collusion of insiders, CBC's eventual failure would have been very difficult to prevent. While the examination is not designed to specifically uncover fraud and is not a substitute for an audit program, we will continue to evaluate and refine our policies and procedures.

APPENDIX V

CONNECTICUT DEPARTMENT OF BANKING RESPONSE

STATE OF CONNECTICUT

DEPARTMENT OF BANKING

260 CONSTITUTION PLAZA • HARTFORD, CT 06103-1800

John P. Burke
Commissioner

March 7, 2003

Russell A. Rau
Assistant Inspector General for Audits
Federal Deposit Insurance Corporation
Office of Audits
Office of Inspector General
Washington, D.C. 20434

Dear Mr. Rau

Thank you for providing this Department with a copy of the draft report entitled "Material Loss Review of the Failure of the Connecticut Bank of Commerce, Stamford, Connecticut." I've reviewed the contents of the report and feel the review is reasonably presented. Obviously, we feel we acted appropriately during our supervision of the Connecticut Bank of Commerce and tried to work with its management to address issues raised by examiners. At the point where we were certain that fraud had, in fact, taken place, I acted as expeditiously and decisively as possible to close the institution and limit any further loss to the FDIC.

Your recommendations are entirely appropriate. During 2002 this Department ran two sessions on corporate governance and in total approximately 350 directors from state and federally chartered depositories located in Connecticut attended. We run these sessions as often as needed and will continue to provide relevant educational opportunities for bank directors.

During our consideration of the merits of the acquisition of MTB Bank by the Connecticut Bank of Commerce we assessed the financial strength of the major shareholder and whether the injection of $20 million could be made from the resources presented on the financial statement provided. We determined it could and, in fact, received a letter from the major shareholder confirming that the capital injection would be made from personal resources. Much of this persons financial resources consisted of ownership in various corporations and throughout the period covered in your review, we relied on information that is publicly available. In addition, we felt the major shareholder had provided capital support to the institution on several occasions prior to the MTB transaction and this "track record" was also a consideration.

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FAX: (860) 240-8178
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website: http://www.state.ct.us/dob/

The Department has proposed legislation that will, if enacted, address the issue you identify in our current lending limit. Specifically, to aggregate the liabilities of one obligor with that of another obligor of a Connecticut bank for purposes of calculating the limitations on the loans to one obligor, such as when the proceeds of a loan to one obligor are to be used for the direct benefit of another person or a common enterprise is deemed to exist between such persons.

We appreciate the time devoted to this review and the recommendations put forth will be fully considered. If you have questions concerning this letter, please feel free to contact me.

Sincerely,

John P. Burke
Banking Commissioner

Cc: Michael Zamorski, Director
Division of Supervision and Consumer Protection
Christopher Spoth, Regional Director
John C Colantoni, Sr. Audit Specialist

APPENDIX VI

MANAGEMENT RESPONSES TO RECOMMENDATIONS

This table presents the management responses that have been made on recommendations in our report and the status of recommendations as of the date of report issuance. The information in this table is based on management's written response to our report.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved[a]: Yes or No	Dispositioned[b]: Yes or No	Open or Closed[c]
1	DSC concurs with the recommendation and will continue to consider requiring prior notice of all material transactions when it is deemed necessary and beneficial. This topic will be addressed during the periodic teleconferences DSC currently has with each regional office to discuss enforcement actions in process. The draft report and DSC's response will also be discussed at the DSC senior management meeting during the week of March 10, 2003 with all of DSC regional directors.	December 31, 2003	N/A	Yes	No	Open
2	DSC concurs with the recommendation and will review the *Case Managers Procedures Manual* to determine whether more guidance regarding the assessment of management during the review of mergers and acquisitions should be added.	September 30, 2003	N/A	Yes	No	Open
3	DSC did not agree with this recommendation; however, it will review the *Case Managers Procedures Manual*, and consider adding or clarifying the guidance related to the review and/or validation of funding sources in connection with mergers and change of control notices. Also, this report will be discussed at the senior management meeting with all DSC regional directors during the week of March 10, 2003.	September 30, 2003	N/A	Yes	No	Open

4	DSC concurs with the recommendation and believes the recommendation reflects standard, longstanding examination practices within the Division. Guidance issued to examiners in 2001 and updated in 2003 will be provided to the OIG.	March 31, 2003	N/A	Yes	No	Open
5	DSC concurs with the recommendation and believes that current guidance and the distribution of the OIG Report provides FDIC staff with sufficient direction and emphasis on the issues raised in this recommendation. This report will be discussed at the next DSC senior management meeting in March 2003.	December 31, 2003	N/A	Yes	No	Open

[a] Resolved – (1) Management concurs with the recommendation and the planned corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation but planned alternative action is acceptable to the OIG.
(3) Management agrees to the OIG monetary benefits or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Dispositioned – The agreed-upon corrective action must be implemented, determined to be effective, and the actual amounts of monetary benefits achieved through implementation identified. The OIG is responsible for determining whether the documentation provided by management is adequate to disposition the recommendation.

[c] Once the OIG dispositions the recommendation, it can then be closed.

GLOSSARY

<table>
<tr><td>Adversely Classified Assets</td><td colspan="2">Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) to three categories:
• Substandard,
• Doubtful, and
• Loss</td></tr>
<tr><td>Call Report</td><td colspan="2">An institution’s quarterly Consolidated Report of Condition and Income which contains a balance sheet, income statement, and other detailed financial schedules containing information about the institution.</td></tr>
<tr><td rowspan="6">CAMELS Rating or Composite Rating</td><td colspan="2">CAMELS (an acronym for capital, asset quality, management, earnings, liquidity, and sensitivity to market risk) represents the overall rating given to a bank based on the six components above. A rating of “1” through “5” is given, with “1” having the least regulatory concern and “5” having the greatest concern. A description on the graduations utilized in conjunction with the performance ratings is as follows:</td></tr>
<tr><td>Rating “1”</td><td>Indicates strong performance, significantly higher than average.</td></tr>
<tr><td>Rating “2”</td><td>Reflects satisfactory performance, performance which is average or above: this includes performance that adequately provides for the safe and sound operation of the bank.</td></tr>
<tr><td>Rating “3”</td><td>Represents performance that is flawed to some degree and as such is considered fair. It is neither satisfactory nor unsatisfactory but is characterized by performance that is below-average quality.</td></tr>
<tr><td>Rating “4”</td><td>Refers to marginal performance, significantly below average. If left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.</td></tr>
<tr><td>Rating “5”</td><td>Considered unsatisfactory; performance that is critically deficient and in need of immediate remedial attention. Such performance, by itself or in combination with other weaknesses, threatens the viability of the institution.</td></tr>
<tr><td>Cease and Desist Order (C&D)</td><td colspan="2">A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. A C&D may be terminated when the bank’s condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.</td></tr>
</table>

Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. A concentrations schedule is one of the pages that may be included in the Report of Examination. As a general rule, concentrations are listed by category according to their aggregate total and are reflected as a percentage of Tier 1 Capital.
Division of Resolutions and Receiverships (DRR)	The division of the FDIC that plans and handles the resolution and liquidation of failed FDIC-insured institutions.
Executive Officer	Executive officer of a company or bank means a person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company or bank, whether or not: the officer has an official title; the title designates the officer an assistant; or the officer is serving without salary or other compensation. The chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer of a company or bank are considered executive officers, unless the officer is excluded, by resolution of the board of directors or by the bylaws of the bank or company, from participation (other than in the capacity of a director) in major policymaking functions of the bank or company, and the officer does not actually participate therein. *[Codified to 12 C.F.R. § 215.2(e)(1)]*
Insider	A person who is or is proposed to be a director, officer, organizer, or incorporator of an applicant; a shareholder who directly or indirectly controls 10 percent or more of any class of the applicant's outstanding voting stock; or the associates or interests of any such person. Institution-affiliated party shall have the same meaning as provided in section 3(u) of the Act (12 U.S.C. 1813(u)). *[Codified to 12 C.F.R. § 303.2]*
Loan Loss Reserve also called Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain a Loan Loss Reserve level that is adequate to absorb the estimated credit losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the loan loss reserve should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as standby letters of credit.

Principal Shareholder	A person that directly or indirectly, or acting through or in concert with one or more person, owns, controls, or has the power to vote more than 10 percent of any class of voting securities of a member bank or company. Shares owned or controlled by a member of an individual's immediate family are considered to be held by the individual. *[Codified to 12 C.F.R. § 215.2]*
Prompt Corrective Action (PCA)	Part 325 of the FDIC Rules and Regulations, 12 CFR §325.101, et. seq, implements section 38 of the FDI Act, 12 U.S.C. §1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are not adequately capitalized. The following terms are used to describe capital adequacy: • Well Capitalized • Adequately Capitalized • Undercapitalized • Significantly Undercapitalized • Critically Undercapitalized
Red Flags	A warning sign that something may not be right. In this report it refers to irregular or unusual activity at the bank.
Regulation O	The Federal Reserve regulation that restricts the amount of credit banks may extend to their own executive officers, directors, and principal shareholders.
Section 10(b) of the FDI Act	Section 10(b), 12 U.S.C. §1820(b) lists the power of the Board of Directors to appoint examiners to conduct regular and special examinations of financial institutions. Also, examiners shall have the power, on behalf of the Corporation, to make such examinations of the affairs of any affiliate of any depository institution as may be necessary to disclose fully the relationship between the institution and its affiliate and the effect of the relationship on the institution.
Section 10(c) of the FDI Act	Section 10(c) of the FDI Act, 12 U.S.C. §1820(c), authorizes the representative of an appropriate Federal banking agency to administer oaths and affirmations, and to examine and take and preserve testimony under oath as to any matter in respect to the affairs or ownership of any such bank, institution, or affiliate.
Section 23(a)	Section 23(a) of the Banking Affiliates Act of 1982, 12 U.S.C. §371(c), establishes restrictions on transactions between financial institutions and their affiliates. These include restrictions on the dollar amount involved in the transactions and establishes collateral requirements for certain transactions with affiliates.

Section 23(b)	Section 23(b) of the Banking Affiliates Act of 1982, 12 U.S.C. §371(c)-1, places restrictions on transactions with affiliates. It requires transactions to be on the same terms and standards or at least as favorable as those prevailing for comparable transactions with a nonaffiliate. In the absence of comparable transactions, they must be on terms and circumstances that in good faith would be offered to or apply to nonaffiliated companies.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. §325.2 (A), and is the sum of : • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; • Minority interest in consolidated subsidiaries; **Minus** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Tier 1 Leverage Capital Ratio	Tier 1 Capital divided by total assets.
Tier 2 (Supplemental) Capital	Tier 2 Capital is defined in Part 325 of the FDIC Rules and Regulations, 12 CFR §325, Appendix A., I.A.2, and generally consists of: • Allowances for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets; • Cumulative perpetual preferred stock, long-term preferred stock and related surplus; • Perpetual preferred stock (dividend is reset periodically); • Hybrid capital instruments; • Term subordinated debt and intermediate-term preferred stock; and • Eligible net unrealized holding gains on equity securities.

APPENDIX VIII

PREVIOUSLY ISSUED MATERIAL LOSS REVIEW REPORTS*

- **The Failure of Pacific Thrift and Loan Company, Woodland Hills, California**
  (Issue date: June 7, 2000)
- **The Failure of BestBank, Boulder, Colorado**
  (Issue date: January 22, 1999)
- **The Failure of First Trust Bank, Ontario, California**
  (Issue date: May 16, 1997)
- **The Failure of the Bank of Newport, Newport Beach, California**
  (Issue date: October 8, 1996)
- **The Failure of Pacific Heritage Bank, Torrance, California**
  (Issue date: January 26, 1996)
- **The Failure of The Bank of Hartford, Hartford, Connecticut**
  (Issue date: December 1, 1995)
- **The Failure of The Bank of San Pedro, San Pedro, California**
  (Issue date: December 21, 1994)
- **The Failure of The Bank of San Diego, San Diego, California**
  (Issue date: April 29, 1994)

* On February 14, 2003, our office began a material loss review of Southern Pacific Bank, Torrance, California, which failed February 7, 2003 causing an estimated loss of $134.5 million to the Bank Insurance Fund.