

Recommendations

We recommend that the Director of the Division of Supervision

- (1) Modify the *DOS Manual of Examination Policies* to address how examiners should handle situations where access to bank employees and records is impeded during an examination, and
- (2) Establish a remedy for the FDIC to gain immediate, unfettered access to an insured depository institution that attempts to impede the examiners' access to bank employees or records.

DOS Missed Opportunities for Timely and Effective Supervisory Actions

While DOS conducted timely examinations and appropriately applied Prompt Corrective Action (PCA) provisions, we concluded that DOS missed opportunities to take more timely and effective supervisory actions at critical junctures in BestBank's history. The Background section of this report includes a table of examinations and supervisory actions related to BestBank.

DOS Did Not Take Timely and Effective Supervisory Actions

In our opinion, the FDIC missed opportunities for more timely and effective supervisory actions when DOS

- terminated the Cease and Desist Order in October 1995, prior to implementing a Memorandum of Understanding,
- rated the bank a "4" in February 1996 but did not implement any supervisory action, and
- rated the bank a "3" in October 1996 and 1997 without substantiating Century's ability to continue indemnifying the losses in the expanding subprime credit card portfolio. When bank management refused to enter into an MOU based on the results of the October 1996 examination, DOS accepted Board Resolutions instead.

An MOU may be considered a stronger supervisory action than Board Resolutions because an MOU is a two-party contract prepared and signed by the banking regulators and the bank's board of directors. Board Resolutions, on the other hand, are prepared and approved solely by the bank's board of directors. Although DOS contemplated an MOU and subsequently a C&D based on the results of the October 1997 joint examination, DOS did not take either action before the bank was closed in July 1998.

Considering bank management's actions prior to these events, including ceding control of a substantial portion of the bank's business to a non-regulated third party, we believe DOS should have taken additional action to address bank management's inadequate planning and controls related to the bank's risky business ventures.

DOS Terminated Cease and Desist Order in October 1995

DOS terminated a C&D in October 1995 after accepting Board Resolutions in lieu of an MOU. In our opinion, this action seemed unusual considering the difficulty the FDIC had experienced implementing the C&D, which was based on the results of the October 1992 examination. FDIC staff devoted significant time and effort pursuing this enforcement action throughout 1993; however, bank management did not stipulate to the C&D until January 1994. Although the bank was in substantial compliance at the January 1995 examination, several provisions had not been fully addressed. The examiners recommended that these outstanding provisions, as well as other significant concerns raised during the examination, be included in an MOU. DOS drafted the MOU and agreed to terminate the C&D once the MOU had been signed. However, when bank management refused to sign the MOU, DOS agreed to accept Board Resolutions instead. After the bank adopted the Board Resolutions, DOS terminated the C&D.

Weaknesses Identified in February 1996 Joint Examination Did Not Result in Supervisory Action

In February 1996, the FDIC and the State concluded the bank was a composite "4" and had not complied with half of the Board Resolutions adopted in September 1995. The FDIC and the State contemplated an MOU that would address the weaknesses identified at the February 1996 joint examination, including

- inadequate controls over the bank's merchant processing program,
- executive bonuses paid without regard to the bank's capital levels,
- inadequate allowance for loan and lease losses,
- weak controls over the bank's loan and appraisal review processes,
- lack of a conflict of interest policy to monitor insider dealings, and
- lack of adherence to laws and regulations.

However, neither the FDIC nor the State implemented a supervisory action.

According to the *DOS Manual of Examination Policies*, "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." Although there are exceptions to this policy in certain cases, the Manual provides: "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'."

Following the February 1996 joint examination, BestBank's CEO submitted allegations to the FDIC Chairman regarding the conduct of DOS examiners during past examinations. The FDIC Chairman asked the OIG to look into these allegations. According to FDIC officials in the regional and field offices, the FDIC Chairman's referral of the CEO's allegations and OIG's inquiry into these allegations had a "chilling effect" on the FDIC staff. However, the OIG did not fully substantiate any of the allegations, found several of the allegations to be without merit, and generally concluded that examiners followed applicable FDIC policies and procedures. (See appendix A, Excerpt From OIG's *Review of the Allegations Regarding the Federal Deposit Insurance Corporation's Supervision of BestBank in Boulder, Colorado*, dated July 10, 1996.) Although the details of the OIG's findings were provided to DOS management in Washington, the examiners stated that these details were not provided to the DOS staff. According to the examiners, DOS management only conveyed that the OIG's report "exonerated" the examiners. As a result, some DOS personnel became sensitive regarding communication with bank management. FDIC officials also were concerned that bank management would perceive any supervisory action as retaliation for the allegations. Accordingly, DOS decided to re-evaluate the need for supervisory action depending on the results of the October 1996 examination. In our opinion, DOS should not have allowed the CEO's allegations, the FDIC Chairman's request that the OIG review the allegations, or the OIG's subsequent inquiry to influence DOS's decision to pursue supervisory action on a "4" rated institution.

Lack of Reliable Financial Data Hindered October 1996 and 1997 Examinations

In October 1996, the FDIC and the State rated BestBank a composite "3," with asset quality rated a "2."¹ The examiners concluded that bank management relied extensively on Century to indemnify losses in the credit card portfolio. According to the examiners, the majority of the bank's asset growth (from \$42 million at June 30, 1996 to \$54 million at November 11, 1996) was attributed to credit card receivables. The FDIC contemplated an MOU that would address the weaknesses identified at the October 1996 examination, including

- inadequate capital and liquidity levels, which were directly related to the significant growth in credit card receivables;
- poor supervision and monitoring of third-party service providers, such as Century; and
- weak internal controls over several operational areas of the bank.

However, when bank management refused to sign the MOU, DOS again accepted Board Resolutions instead.

¹ According to the Uniform Financial Institutions Rating System, an asset quality rating of "2" indicates satisfactory asset quality and credit administration practices. Also, the level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. In addition, risk exposure is commensurate with capital protection and management's abilities.

In October 1997, the FDIC and the State again rated BestBank a composite “3,” with asset quality rated a “2.” The examiners determined that bank management continued to rely on Century to indemnify losses in the credit card portfolio. According to the examiners, the Century-related credit card receivables had grown from \$44.9 million at December 31, 1996 to \$117 million at October 23, 1997. The FDIC and the State determined that the bank was not in compliance with the outstanding Board Resolutions and contemplated an MOU that would address the weaknesses identified at the October 1997 joint examination, including

- inadequate capital and liquidity levels, which were directly related to the significant growth in credit card receivables;
- a failure to obtain Century’s audited financial statements to evaluate Century’s ability to indemnify the bank for future losses in the subprime credit card portfolio;
- inadequate strategic planning related to the credit card receivables;
- a concentration in credit card receivables involving subprime borrowers; and
- inadequate loan documentation procedures for credit card receivables and other loans.

The FDIC and the State planned to pursue a C&D if bank management refused to sign the MOU. Neither agency implemented a C&D or entered into an MOU before the bank was closed. The FDIC did initiate a section 10(c) investigation in June 1998 related to the BestBank/Century credit card program.

Although the examiners were concerned about the bank’s unrestrained growth and poor underwriting practices in October 1996 and 1997, the examiners concluded that Century had demonstrated a willingness and ability to purchase delinquent credit card accounts. The examiners admitted, however, that they could not determine whether Century had the financial capability to continue purchasing delinquent accounts in the future. In fact, the examiners questioned the integrity of Century’s financial statements, because there were substantial monthly changes in account balances that the examiners would have liked to investigate further had they been provided access to Century. Although the examiners noted that Century had promised bank management audited financial statements for 1995 and 1996, these financial statements were not provided to the examiners. Also, the examiners were concerned that Century retained only \$1,000 in capital from year to year, because this resulted in Century’s complete dependence on current cash flows to honor the indemnification agreement.

Based on our review and discussions with examiners, we found that DOS did not have reliable or sufficient information at the October 1996 and 1997 examinations to evaluate Century’s financial capability to continue purchasing delinquent credit card accounts. We believe DOS needs to develop and implement a policy regarding how examiners should address scope limitations during an examination. For instance, the policy could provide that significant scope limitations during an examination will be considered an unsafe and unsound practice justifying a composite “5” rating for the institution.

DOS Used Prompt Corrective Action Appropriately

The Congress enacted section 38 of the FDI Act, Prompt Corrective Action, to ensure regulatory intervention when an insured institution's capital falls below specified minimum levels. BestBank technically became "undercapitalized" based on its risk-based capital ratio in the December 31, 1996 Call Report. Due to subsequent adjustments by DOS's Call Reports Analysis Section in Washington, the risk-based capital ratio was 7.99 percent, just under the 8 percent minimum level for adequately capitalized institutions. DOS elected not to initiate the PCA requirements for undercapitalized institutions because the bank was in the process of completing a preferred stock sale, which was concluded shortly thereafter. DOS did implement the PCA provision on July 22, 1998 when the examiners determined that BestBank was insolvent. DOS notified the bank that it was critically undercapitalized and subject to mandatory PCA requirements based on the results of the June 1998 joint examination. The Colorado State Banking Board closed BestBank the following day.

Recommendations

We recommend that the Director of the Division of Supervision

- (3) Modify existing policies to require the Regional Director to provide a written justification for taking no supervisory action on a "3," "4," or "5" rated institution, and

- (4) Develop and implement a policy regarding how examiners should address scope limitations during an examination. For instance, the policy could provide that significant scope limitations during an examination will be considered an unsafe and unsound practice justifying a composite "5" rating for the institution.

Communication and Coordination Related to Examinations Needs to Be Enhanced

As part of our overall assessment of the FDIC's supervision of BestBank, we identified specific instances where DOS can strengthen communication and coordination within the Corporation and with State banking agencies. While supervising BestBank, FDIC staff encountered several situations where clear communication and coordination policies related to allegation referrals, consumer complaints, and examination obstacles may have resulted in earlier intervention or more timely supervisory actions.

Allegations Were Not Referred to Proper Authorities

In two instances, DOS received verbal allegations related to BestBank and/or Century applying credits to cardholder accounts to keep them current. In both cases, the allegations were not referred to the DOS Dallas Regional Director, Dallas Regional Counsel, or the OIG.

In December 1996, a former BestBank employee contacted the State with allegations regarding the bank's relationship with Century. According to the allegations, Century had (1) "re-aged" 45 percent of the monthly credit card accounts and (2) applied credits to make the accounts appear current without receiving payments. Allegedly, BestBank's president was aware of the re-aging practice. The former employee also alleged that \$1.5 million in receivables had been recorded without issuing credit cards on the accounts. According to the allegations, these false receivables were later removed from the books. In January 1997, the FDIC EIC notified DOS Dallas that some of the information supplied by the former employee had been substantiated, but the extent of the allegations could not be determined without a full audit or investigation, which was not pursued.

In March 1998, DCA Dallas received an anonymous call alleging that a bank in the Denver metropolitan area had been generating credits internally to avoid charging off credit card loans. The DCA examiner appropriately referred the allegation to DOS's Denver field office. The DOS examiners determined that the allegation was related to BestBank and notified DOS Dallas. However, DOS took no further action.

Considering the nature of the allegations and bank management's uncooperative behavior in the October 1996 and 1997 examinations, we believe DOS should have taken prompt action to address the allegations, including a referral to the Dallas Regional Director, the Dallas Regional Counsel, and the OIG. As noted earlier in the report, the Dallas Regional Counsel believes the FDIC could have gained access to Century by initiating a section 10(c) investigation into the allegations. We believe action of this type, even in early 1998, could have identified the extent of BestBank's problems and diminished the loss to the BIF.

Consumer Complaints Related to BestBank Were Not Routinely Reviewed by DOS Examiners

DOS, DCA, and the State were not aware of the volume and nature of complaints filed against BestBank, because there is no formal mechanism for referring consumer complaints from one division or agency to another in cases where an institution has been identified as a regulatory concern. In the 2 years preceding BestBank's failure, consumers filed a total of 41 complaints with the FDIC, the State, and BestBank regarding the Universal Travel/All Around Travel credit card programs. Five complaints concerned credit card statements with \$20 credits that were not cardholder payments. We address the \$20 credits in the Causes of BestBank's Failure and the Resulting Material Loss to the Bank Insurance Fund section of this report. All 41 complaints alleged that consumers either had not applied for the credit card or wanted to cancel the card.

While DCA is responsible for addressing consumer complaints, it is DCA's practice to notify DOS when an inordinate number of complaints have been received on an institution. It is also DCA's practice to refer complaints to the State if the subject matter is covered by state jurisdiction. In the case of BestBank, DCA did not consider the volume of complaints related to the travel program to be significant because FDIC

received only 15 of the 41 complaints and the remainder went only to the State or BestBank. DOS examiners became aware of the volume and, more significantly, the nature of the complaints following the May 1998 visitation. Accordingly, the examiners expanded the joint visitation into a full scope joint examination. Since consumer complaints can, and in this case did, lead to questions that may raise potential safety and soundness issues, we believe DOS examiners need to periodically review the consumer complaint files when an institution has been identified as a regulatory concern.

Examination Obstacles Were Not Documented or Referred to the Appropriate Organizational Level

During the October 1996 and 1997 examinations, FDIC examiners encountered significant obstacles that were not documented and referred to the appropriate organizational level for resolution until July 1998. As noted earlier in this report, bank management continued to impede the examiners' access to bank employees and records during the October 1996 and 1997 examinations. In addition, FDIC examiners concluded that they needed more time to complete the October 1997 joint examination. In our opinion, examination obstacles need to be fully documented at the time they occur. Further, the Regional Director's resolution of such situations should also be recorded.

In October 1996, the Dallas Regional Director instructed the examiners to discontinue the examination because the CEO refused to rescind the bank's restrictive guidelines for conducting the examination. Although bank management subsequently rescinded the guidelines, the examination team admitted that bank management continued to enforce the guidelines impeding access to employees and records during this examination, as well as the October 1997 joint examination. Considering the severity of bank management's actions, we believe the examiners should have documented the situation promptly, including the Regional Director's resolution of the issue. In addition, this information should have been forwarded to DOS headquarters management in Washington.

In October 1997, FDIC examiners concluded that they needed additional time to complete the joint examination. The State, which was the lead agency on this examination, had allocated approximately 2 weeks to complete the on-site work. After analyzing examination data related to the October 1996 and 1997 examinations, we made the following observations:

- The 1997 on-site examination schedule was reduced by approximately 3 weeks (from 5 weeks in October 1996 to a little over 2 weeks in October 1997).
- The 1997 on-site examination hours were reduced by 31 percent (from 888 hours in 1996 to 617 hours in 1997).
- The bank's assets had grown over 164 percent between the October 1996 and 1997 examinations (from \$42 million at June 30, 1996 to \$111 million at June 30, 1997).

The FDIC EIC and others on the examination team stated that the EIC asked the Dallas Regional Office for additional time to complete the October 1997 joint examination, but the extension was not granted. However, DOS Dallas officials do not recall this request.

Also, during the examination, the EIC was required to attend a 2-day Field Office Supervisor conference. We believe this situation illustrates the need for examiners to document significant examination obstacles. Further, the Regional Director's resolution of the problem should be recorded to ensure that these issues are referred to and addressed by the appropriate management level.

Recommendations

To strengthen communication and coordination within the Corporation and with State banking agencies, we recommend that the Director of the Division of Supervision

- (5) Develop and implement a policy where examiners take prompt action to address allegations of potential wrongdoing, including referring such allegations to the Regional Director, Regional Counsel, and, in certain circumstances, the OIG;
- (6) Develop and implement a policy where examiners, as part of DOS's quarterly off-site review and pre-examination planning work, review DCA and State consumer complaint files on financial institutions that have been identified as a supervisory concern; and
- (7) Develop and implement a policy that requires examiners to document significant examination obstacles, such as impeded access to bank employees and records or unrealistic time constraints, including the Regional Director's resolution of such obstacles.

OIG Believes Expanding and Clarifying DOS Policies Will Benefit the Supervisory Process

As part of our overall assessment of the FDIC's supervision of BestBank, we identified certain instances where DOS can improve the supervisory process by expanding and clarifying policies and procedures. Specifically, DOS guidelines do not address the evaluation of subprime credit card lending and the examiners did not fully comply with DOS policies and procedures related to assessing compliance with outstanding supervisory actions, identifying concentrations of credit, preparing the pre-examination planning memorandum, and scheduling board meetings.

While DOS's *Credit Card Specialty Bank Examination Guidelines*, dated May 1997, provide helpful instruction related to the examiner's evaluation of a bank's credit card operations, the guidelines do not specifically address subprime credit card lending. Considering the impact this particular type of credit card lending had on BestBank (and may have on other institutions), we believe specific guidance in this area is warranted.

Examiners did not fully comply with DOS policies and procedures in the following situations:

- The October 1996 examination report did not assess BestBank's compliance with outstanding Board Resolutions from September 1995. At the prior examination, bank management had not adhered to half of the outstanding resolutions. According to the *DOS Manual of Examination Policies*, the examination report should address the institution's adherence to outstanding formal and informal administrative actions, including Board Resolutions.
- The October 1996 and 1997 examination reports did not specifically identify the BestBank/Century credit card programs as a concentration of credit based on Tier 1 Capital at the time. According to the *DOS Manual of Examination Policies*, examiners should use the concentrations schedule of the examination report to emphasize the possible absence of risk diversification within the institution. Concentrations aggregating 25 percent or more of Tier 1 Capital include concentrations by a single repayment source with normal credit risk or greater.

Although not specifically identified as a concentration of credit based on Tier 1 Capital levels in the October 1996 and 1997 examination reports, we calculated that the BestBank/Century credit card receivables represented 579 percent and 1,179 percent of Tier 1 Capital at September 30, 1996 and September 30, 1997, respectively. The June 1998 joint examination report identified the concentration as 971 percent of Tier 1 Capital. Considering that BestBank completely relied on Century to administer the portfolio and indemnify the bank for any losses, we believe these receivables should have been identified as a concentration of credit based on Tier 1 Capital levels in the October 1996 and 1997 examination reports.

- The examiners did not prepare a pre-examination planning memorandum for the October 1996 examination. According to the *DOS Manual of Examination Policies*, the pre-examination memorandum, which outlines the proposed scope of the examination, is required for all examinations. This memorandum identifies the work to be performed, areas that require special attention, and staffing needs, including the number and expertise of personnel required. According to the EIC, the pre-examination work was completed, but the results were not documented.
- The FDIC and the State did not schedule the BestBank board meeting to discuss the results of the October 1997 joint examination until almost 6 months after the examination was completed. According to the examiners, BestBank's CEO would not schedule a board meeting until the directors had received the final copy of the examination report. Although the State transmitted the final report to the bank on February 2, 1998, the board meeting was not held until April 20, 1998.

According to the *DOS Manual of Examination Policies*, the EIC should meet with the board during, or subsequent to, the examination. Although the Manual does not provide specific timeframes, we believe the April 1998 board meeting was not timely. This board meeting was significant because, as a

result of the discussion, bank management provided a cash flow analysis to convince the regulators that BestBank could survive without Century. However, in the May 1998 visitation, the examiners concluded that bank management's projections could not be validated. In hindsight, it appears that an earlier board meeting may have resulted in more timely supervisory action.

Recommendations

We recommend that the Director of the Division of Supervision

- (8) Expand DOS's *Credit Card Specialty Bank Examination Guidelines* to include policies and procedures for examining subprime credit card lending, and

Issue policy reminders to DOS examiners and supervisors related to assessing compliance with outstanding supervisory actions, identifying concentrations of credit, preparing the pre-examination planning memorandum, and scheduling board meetings.