Appeals Process

Appeal 1—Appeal of Memorandum of Understanding

Background

A bank appealed the OCC's decision not to terminate an informal enforcement action (action). The action was placed on the bank to address concerns regarding credit administration issues and a high level of criticized assets that were not being dealt with in a satisfactory manner. The appeal stated that each of the items in the action had been addressed with changes in policies and procedures made and implemented. The last report of examination stated that the bank was in full compliance with the MOU. In addition, a letter from the supervisory office absolved the bank from any reporting requirements under the action.

Discussion

While the supervisory office acknowledged that the bank was in compliance with all of the articles of the action and had been absolved from the reporting requirements, the decision to keep the under the action was primarily to:

- Make sure that it continued to address the existing asset quality problems, and
- Ensure that the initiatives implemented as a result of the action became an integral component of the credit culture.

Conclusion

Considering all of the dimensions of the action coupled with the current asset quality concerns, the ombudsman determined that the existing informal action was not the best vehicle to address the current concerns. Therefore, the supervisory office terminated the action and replaced it with a written commitment from the board of directors. The directorate committed to continue the same lending practices that brought the bank into compliance with the former action and dedicated their best efforts to reduce classified assets to an acceptable level. Each of the members of the board signed the new resolution.

Appeal 2—Appeal of OCC's Objection of a Director for a Bank-in-Organization

Background

The ombudsman received an appeal from an individual who the OCC objected to as serving as a director of a bank-in-organization.

The proposed director stated in his appeal that his character and integrity had been challenged based on erroneous assumptions and conclusions. He further stated that to allow the decision to stand without a challenge would imply acceptance of the fairness of the decision and the conclusions made in the licensing process.

The proposed director had pleaded guilty to a misdemeanor that was later expunged after a settled repayment of funds and community service. The proposed director's Interagency Biographical and Financial Report submitted with the charter application initially described the charge as a personal-property dispute. The Licensing department concluded that the individual was not forthright in the written application and disclosures regarding the background investigation, nor did he effectively address issues surrounding the conviction when asked to do so in writing or orally.

Discussion

Sections 12 CFR 5.20 (g)(3)(i) *Financial Resources* states that:

> Each organizer must have a history of responsibility, personal honesty, and integrity. Personal wealth is not a prerequisite to become an organizer or director of a national bank. However, director stock purchases, individually and in the aggregate, should reflect a financial commitment to the success of the national bank that is reasonable in relation to the individual and collective financial strength. A director should not have to depend on bank dividends, fees, or other compensation to satisfy financial obligations.

The statute, 12 CFR 5.20 (f)(2) ii) *Policy Considerations* further states that:

> The Office of the Comptroller may also consider additional factors listed in section 6 of the Federal Deposit Insurance Act, 12 USC 1816, including the risk to the Federal deposit insurance fund, and whether the proposed bank's corporate powers are consistent with the purposes of the Federal Deposit Insurance Act and the National Bank Act.

Conclusion

The ombudsman considered all aspects of the case, reviewing all documentation from the Licensing department, interviews with the individual as well as the supervisory office. The information obtained in the ombudsman's review was not inconsistent with the provisions of the statute. Therefore, the ombudsman did not reverse the decision to object to the individual serving as a director of the bank-in-organization.

Appeal Summary 3—Appeal of Nonaccrual Status

Background

Several banks appealed the nonaccrual decision reached during the Shared National Credit (SNC) review process. While the banks agreed with the assigned substandard classification, they did not agree with the nonaccrual decision. Each of the banks believed that their loans were well secured and in the process of collection.

Each bank's security interest included a perfected lien in the equity interest of the partnership with the exception of one, who had a direct interest in the underlying assets. During the year, the holding company and its operating subsidiaries and partnerships declared bankruptcy. Revelations of financial misrepresentation led to disruption and a change in external auditors for the year-end statement audit. Additionally, they failed to file timely year-end financial statements. A subsequent liquidity crisis ensued owing to a loss of access to the capital markets and the inability of the company to meet impending bond interest and other payments.

Since all of the facilities were similarly structured and the company co-mingled funds, the SNC team concluded that compelling support existed to view each facility on a substantively consolidated basis. Issues of well-secured and in the process of collection posed continuing uncertainties that remained unresolved, making accrual of interest and income recognition inappropriate.

Discussion

The decision on whether a bank places a loan on nonaccrual should be determined in accordance with the Federal Financial Interagency Examination Counsel (FFIEC) Call Report Instructions (call report). The general rule is that an asset should be placed on nonaccrual when principal or interest is 90 days or more past due or payment in full of principal or interest is not expected, unless the asset is well secured and in the process of collection. According to the *Comptroller's Handbook* booklet, "Rating Credit Risk" (April 2001), there is no requirement that a loan must be delinquent for 90 days before it is placed on nonaccrual. Once reasonable doubt exists about a loan's collectibility, the loan should be placed on nonaccrual. When payment performance

depends on the drawing on lines of credit, the bank advancing additional loan funds, or the bank extending excessively lenient repayment terms, the loan should be considered for nonaccrual status. The key issues to consider are the collectibility of the loan and the concepts of well-secured and in the process of collection.

Well-Secured

According to the call report and the handbook booklet, a "well-secured" asset is secured by a lien or pledge of collateral that has a realizable value sufficient to discharge the debt fully (including accrued interest), or it is secured by the guarantee of a financially responsible party.

In determining if the debt was well secured, the ombudsman focused on the marketability and liquidity of the collateral. The bank's support for these factors was limited to historical sales. In reviewing this and other information, there was cause for concern that estimated prices and the premium prices evident in recent years could be sustained based on the availability of future potential buyers and financing for these types of projects given the current market environment. Sales transactions indicated a finite and small number of investors largely trading among themselves. Some of the large companies in the industry have experienced declining financial performance and/or have publicly stated their intention to curtail further acquisitions. Additionally, collateral valuations provided posed other issues for uncertainty due to, ongoing capital expenditures needs, lack of free cash flow for debt payment and future financing support, and changing market dynamics. These issues are not insignificant, given the inability of the parent and its subsidiaries and partnerships to find successful business solutions to these issues outside of bankruptcy.

While buyers for the collateral might be ultimately found at some price over time, the ability to realize any value is encumbered by the bankruptcy court's action. It was anticipated that the bankruptcy proceedings will be protracted, with up to a year or more necessary for the entity to submit a plan of reorganization. The uncertainty of these judicial proceedings imposes additional obstacles in applying the concept of liquidity for credit purposes, already fragile given the absence of a robust number of investors.

In Process of Collection

According to the call report and the handbook booklet, an asset is "in the process of collection" if collection of the asset is proceeding in due course through legal action (including the enforcement of a judgment), or through efforts not involving legal action that are reasonably expected to result in the loan's repayment or in its restoration to a current status in the near future. A 30-day collection period has generally been applied to determining when a loan is "in the process of collection." Customarily an asset can remain in that status more than 30 days only when it can be demonstrated that the timing and amount of repayment is reasonably certain.

The bankruptcy and subsequent imposition of the automatic stay poses substantial challenges to the concept of "in the process of collection." The bankruptcy proceedings are likely to be protracted whereas "in the process of collection" assumes speedy collection that is not obstructed. While the operating subsidiaries have a lien on the assets, without an approved reorganization plan there is uncertainty regarding the timing and source of repayment of the debt.

Financial Analysis

Historical and current financial information was unreliable. Year-end audit work was interrupted following the revelation of accounting irregularities. Lender presentations for post-petition financing are prefaced by comments indicating there is no warranty or representation that the historical financial statements are reliable. A new external auditing firm has been engaged, but has not completed their review. It is uncertain what additional impact this will produce on free cash flow and debt serviceability. It is also uncertain what additional impact this will have on the financial statements at the subsidiary or partnership level.

Notwithstanding the allegations of financial irregularities and the absence of reliable and audited financial information, in all but one of the facilities' year-end 2001 financial statements reflected earnings before interest, taxes, depreciation and amortization (EBITDA) insufficient to fund interest and capital expenditures (CAPEX). Net debt repayments increased this shortage. Capital contributions were required to fund these shortages and also additional WC demands. Consolidated EBITDA is inadequate to meet fixed charges (interest, principal, and CAPEX) and makes collection in full of principal or interest highly uncertain.

Conclusion

In summary, the nature of the collateral and the collateral control available to the senior lenders does not sufficiently meet the tests of well secured. The liquidity and marketability of the collateral pose uncertainties and do not preclude or adequately mitigate the absence of orderly principal reduction that the franchise's free cash flow is incapable of providing. The bankruptcy proceedings and the automatic stay imposed are unlikely to be lifted anytime soon and complicate asset sales. Lengthy reorganization appears unavoidable. Accordingly, the debts cannot be considered as in process of collection. Therefore, the ombudsman concluded that the basis for continuing interest accrual and income recognition is not warranted. The ombudsman advised the banks to closely monitor the status of these severely troubled entities and to independently update the asset classification as circumstances warranted.