25th Anniversary

Appeals Process

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Appeal 1: Of Composite and Component Ratings

Background

The bank's board of directors appealed the downgrade of its overall composite rating and the component ratings for consumer compliance, asset quality, and management. The bank had an overall composite rating of 1 for the last five examinations until the most recent examination when a 2 composite rating was assigned. The board was of the opinion that had the three component ratings been properly rated, a 1 composite rating would have been assigned.

The appeal states that management disagreed with the downgrade in the consumer compliance rating, because they believed the compliance program was sound and there had been no change from the previous examination. The Report of Examination (ROE) noted that the compliance program was satisfactory and stated a bank with a 2 rating is generally in a strong compliance position. It further stated that risk management systems were satisfactory and management responds promptly to audit and regulatory concerns. The ROE notes management plans to implement enhancements to internal controls in response to the OCC's 2004 Fair Lending examination and Bank Secrecy Act weaknesses. These issues were identified internally and confirmed by OCC examiners.

Management disagreed with the asset quality rating of 2 as they believed that asset quality remains strong as evidenced by the low level of classified assets, historical losses, past dues, and nonaccruals. The supervisory office stated that the downgrade in the asset quality rating was attributed to identified weaknesses in risk management practices in the commercial real estate (CRE) portfolio. Specifically, the weaknesses included portfolio and concentration management and reporting, market analysis, appraisal processes, policy exception reporting, and the allowance for loan and lease losses (ALLL). The overall level of risk had increased significantly from the prior examination without a commensurate improvement in risk management practices. Several of these weaknesses were noted at the previous examination.

Management disagreed with the management rating of 2 since they believed the downgrade was the result of the lack of credit risk management processes and weaknesses noted in their trust area. Management believed that the due diligence it performed on the group of trust accounts was adequate. Furthermore, they believed that the supervisory office was overly critical of management's slower-than-expected development of loan concentration reports, analyses, and policies.

The supervisory office stated the downgrade was because of risk management practices lagging behind the bank's substantial growth and change in the loan mix and the lack of due diligence over a group of new trust accounts. Violations of law were noted related to the oversight of these trust accounts.

Management disagreed with the downgrade of the composite rating to 2, because they believed that, if the compliance, asset quality, and management ratings had been appropriately assigned a 1 rating, then this would have resulted in a 1 composite rating. The supervisory office stated that the downgrade was reflective of a higher risk profile, increased leverage, higher concentrations in the loan portfolio, and the need to strengthen credit risk management practices.

Discussion and Conclusion

The ombudsman conducted a review of the information submitted by the bank and supporting documentation from the supervisory office. The review included meetings with the bank's senior management team as well as with members of the supervisory office.

The ombudsman ruled that the conclusion reached by the supervisory office regarding asset quality was appropriate and well supported by the facts at the time of the examination. The ROE and other OCC communications with the bank outlined concerns with the bank's approach to managing and monitoring real estate-related concentrations in the loan portfolio. While the ombudsman agreed with management's quantitative assessment on asset quality, the overall level of risk had increased from the previous examination without a commensurate improvement in risk management practices. The ombudsman was particularly concerned with the board's and management's approach to managing and monitoring concentrations in the lending portfolio.

The ombudsman ruled that the conclusions reached by the supervisory office regarding consumer compliance and management were more reflective of a 1 rating. The ombudsman noted the existence of a strong compliance management program including an efficient system of internal controls. Bank management demonstrated that it understands and is committed to all aspects of compliance risk management. While the ROE did identify areas needing improvement in the compliance area, these can be addressed in the normal course of business and do not materially detract from the overall quality of the compliance program. Furthermore, the bank has a history of substantial compliance with laws and regulations.

The ombudsman noted that the board and management have demonstrated the ability to effectively administer the bank's affairs. This is evident in the strong audit and compliance culture, strong internal control structure, good historical financial performance, and management's depth and knowledge to plan and respond to risks as changes in business conditions occur. While the bank needs to strengthen the credit risk management processes recommended by the OCC supervisory office, the ombudsman believes management has demonstrated over multiple business cycles the ability to implement the needed controls during the normal course of business. Based on these factors, the ombudsman concluded that a 1 rating is more reflective of the management component.

Finally, the ombudsman agreed with the concerns raised by the supervisory office, that the higher risk profile, increased leverage, higher concentrations in the loan portfolio, and the need to strengthen credit risk management practices support the assigned 2 composite rating. Additionally, the bank's low risk-based capital level at the time of the examination and the low ALLL provides little flexibility to handle unforeseen losses of substance.

Appeal 2: Of Composite and Component Ratings

Background

The bank's board of directors appealed the overall composite, capital, and management ratings. A downgrade to a 3 rating was assigned to the composite and capital components. There was no change to the management rating of 3; however, the board believed that based on projected strategic growth and profitability goals, an upgrade to a 2 was warranted. Additionally, the informal Memorandum of Understanding (MOU) issued as a result of the Report of Examination was appealed.

The board disagreed with the assigned capital rating of 3, because the bank had maintained capital above the regulatory minimum level. According to management, the bank's capital level either improved or stayed the same since the previous examination and contended that it was in full compliance with a strategic plan previously submitted to the OCC. Furthermore, management stated that the bank's principal shareholder had demonstrated the capacity to support the bank's capital needs. The supervisory office stated that the downgrade was because of declining capital ratios and the lack of a formal capital plan. Additionally, the supervisory office was concerned with the overall weak earnings trend and that the bank would need a capital injection by year-end 2005.

The board disagreed with the assigned management rating of 3 based on the implementation of their strategic plan. Management stated that the strategic plan was not fully implemented and that the bank had a demonstrated capacity for future growth. Additionally, core earnings were improving rapidly with potential improvement in profitability as the strategic plan continued to be implemented. The supervisory office stated that the key factor in rating management a 3 was the failure of the board and management to ensure that appropriate risk management processes were maintained over the lending area. The supervisory office believed that the bank's rapid loan growth, coupled with weak credit risk management, low capital, and weak earnings posed a high potential for future problems. Subsequent to the examination, the board replaced the president and senior credit administrator in an effort to improve credit administration and overall bank management.

The board disagreed with the composite rating, but provided little support as to why the rating was in error. Management stated that the condition of the bank had not deteriorated from the previous year, but instead had improved dramatically in all key areas. The supervisory office stated that the composite 3 rating was assigned because of a combination of weaknesses in management, capital, and earnings.

The board appealed the MOU, but did not provide support as to what provisions of the MOU it believed were inappropriate. The supervisory office stated that it believed the MOU was appropriate to aid the bank in addressing its long history of weak management, poor financial performance, and weak credit risk management processes. Consideration was given to the fact that the present level of problem assets was not severe and the bank's principal shareholder had a history of providing financial support.

Discussion

The ombudsman conducted a review of the information submitted by the bank and supporting documentation from the supervisory office. The review included discussions with the bank's senior management team as well as with members of the supervisory office.

The ombudsman concurred with the supervisory office's conclusions of the bank's weak financial and managerial deficiencies existing at the time of the examination. While certain aspects of the bank's operations appear to have stabilized, overall financial performance was less than satisfactory. The bank's total asset growth had been erratic and earnings performance had been weak to nonexistent. Tier 1 leverage capital declined from a high of 10.09 percent at year-end 2000 to 6.85 percent at year-end 2004. While asset quality remained satisfactory, credit risk management practices warranted improvement.

Although the earnings rating was upgraded from a 4 to a 3, the ombudsman concluded that earnings from core operations were insufficient to support planned asset growth and augment capital. While nonrecurring items had affected the quantity of earnings, the quality of earnings as the primary source to support future operations was impaired by the bank's below-average net interest margin. Capital levels were insufficient without the capital injections by the principal shareholder.

Conclusion

In conclusion, the ombudsman concluded that the composite rating of 3 assigned at the examination was appropriate and complies with the factors provided in the Uniform Financial Institutions Rating System (UFIRS), (OCC Bulletin 97-1, "Uniform Financial Institutions Rating System and Disclosure of Component Ratings," January 3, 1997). The ombudsman also concluded that the ratings for capital, earnings, and management were appropriate as assigned. Additionally, the ombudsman ruled that the MOU entered into between the board of directors and the OCC was reasonable and in the best interest of the bank.