

Quarterly Journal

APPEALS PROCESS

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Appeal 1—Appeal of Composite and Component Ratings

Background

A bank, currently operating under a consent order for credit card practices, appealed its overall composite rating and the component ratings for capital, asset quality, management, and earnings. Additionally, the bank expressed a desire to appeal the violations of 12 USC 1818 and Section 5 of the Federal Trade Commission Act (FTC Act).

The appeal states that the majority of the report of examination (ROE) portrays an incomplete picture of the bank's condition and fails to recognize substantial steps taken to improve capital, asset quality, management, and earnings. In addition, the alleged violations of law were never mentioned during the examination or at the exit meeting and the bank only became aware of them in the ROE.

According to the appeal, even when considering the subprime nature of its portfolio, the bank has been "well capitalized" for five examinations and its capital ratios remain substantially higher than that required by the OCC. The high loan-loss rates are consistent with forecasts and appropriate allowances are set aside for such losses. In addition, the OCC has praised the bank's risk management processes as "best in its class" with sound credit analytics and underwriting. Earnings are derived from operations, not extraordinary income, and allow for capital accretion as well as provisions to the allowance for loan and lease losses (ALLL). A positive earnings trend was realized for the last seven consecutive years, which included economic downturns. No pending litigation exists. Additionally, management is responsive to regulatory requests and works with its supervisory office on all new initiatives.

The supervisory office response to the appeal stated that the condition of the bank continued to be unsatisfactory due to unacceptable asset quality, questionable quality of earnings, and bare minimum capital levels to support the high-risk profile of the bank. The supervisory office acknowledged that risk management processes have assisted management in operating profitably but that did not mitigate the unsafe and unsound concentrations of risk funded by FDIC-insured deposits.

Discussion

Because of the impending enforcement action, the scope of the ombudsman's review was limited consistent with OCC Bulletin 2002-9, "National Bank Appeal Process." In particular, the violations of law were deemed to be outside of the scope of the appeal. The ombudsman conducted a comprehensive review of the information submitted by the bank and documentation from the supervisory office. The review included meetings with members of the bank's board of directors, senior management team, and legal counsel. The ombudsman also met with members of the supervisory office. The ombudsman's review focused on whether there was adequate support for the assigned ratings and whether the ratings reflected the condition of the bank at the time of the examination.

Conclusion

The ombudsman concurred with the supervisory office regarding the high-risk profile of the bank and upheld the assigned composite rating. Although the violations of law were outside the scope of the appeal, the ombudsman could not ignore their existence and their impact on the component ratings. Therefore, unless the violations were overturned, the component ratings assigned by the supervisory office were also considered reasonable.

In addition to the conclusions reached above, the ombudsman found several instances in which the communication process during the examination, both oral and written, was inconsistent with OCC policies and practices. Of particular concern was the manner and timeliness in which supervisory conclusions and violations of law were communicated to the bank.

Appeal 2—Appeal of Examination Conclusions for Asset Quality, Capital Adequacy, Corporate Governance, Recommended Reserve Allocation, and Designation as "Troubled Condition"

Background

A bank formally appealed the examination conclusions for asset quality, the recommended reserve allocation, capital adequacy, and corporate governance. In addition, the bank appealed its designation as "troubled condition." The bank asked the ombudsman to conduct an independent review of the examination findings.

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The basis of the appeal is the most recent safety and soundness examination in which the bank's composite rating was downgraded from 2 to 3; the component ratings for capital, asset quality, and earnings were downgraded from 2 to 3; management was downgraded from 2 to 5; and liquidity remained unchanged at 2. The appeal also states that the examiners recommended an immediate provision to the allowance for loan and lease losses (ALLL) that was excessive when compared to industry norms and the bank's loss history. According to the appeal, the downgrades are based on aberrations caused by a one-time event (i.e., the acquisition of a federal savings bank) rather than well-established patterns of mismanagement.

The appeal states that, based on its historical composite and component ratings, the bank has always been a well-run institution. Therefore it seems improbable that the condition of the bank had fallen so far and so fast in one year, particularly since the board and management had not changed. According to the appeal, two things had changed: (1) was the acquisition of a troubled federal savings bank (which was approved by the OCC), and (2) the regulatory environment had tightened regarding corporate governance and internal audit.

The supervisory office response stated that the condition of the bank had vastly deteriorated. A series of events and activities negatively impacted the overall condition of the bank. The acquisition of the federal savings bank was inaccurately and untimely accounted for and internal audits were inadequate. Credit risks increased substantially due to improper monitoring and control. This resulted in the need for a substantial provision to the ALLL. Additionally, an international transaction, though resolved without incident, exposed the bank to undue financial risks and raised significant concerns about management and board oversight. The culmination of these deficiencies threatened the viability of the institution and replacing or strengthening management and the board was deemed critical to its survival.

Conclusion

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

The ombudsman opined that the conclusions reached by the supervisory office were well supported by the facts at the time of the examination. The designation of the bank as troubled condition was consistent with agency policies and standards.