

Office of Inspector General



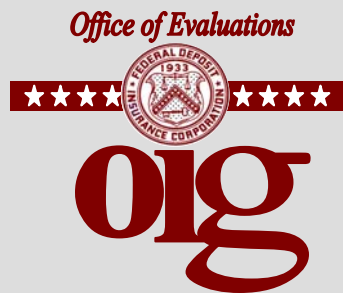
March 2009
Report No. EVAL-09-004

**Controls Over the FDIC's Processing of
Capital Purchase Program Applications
from FDIC-Supervised Institutions**

Office of Evaluations



oig



Background and Purpose of Evaluation

In October 2008, the Congress passed and the President signed the Emergency Economic Stabilization Act of 2008, which established the Office of Financial Stability within the Department of the Treasury (Treasury) and authorized the Troubled Assets Relief Program (TARP). Among other things, the Act provides Treasury with broad, flexible authorities to buy up to \$700 billion in “troubled assets” and allows Treasury to purchase and insure mortgages and securities based on mortgages and, in consultation with the Chairman of the Board of Governors of the Federal Reserve System, purchase any other financial instrument deemed necessary to stabilize financial markets.

Under the TARP, Treasury will purchase up to \$250 billion of preferred stock through a Capital Purchase Program (CPP). The CPP is available to qualifying financial institutions. Treasury will determine eligibility and allocations for interested parties after consultation with the appropriate federal banking agency.

Specifically, in the case of the FDIC, the Corporation will analyze CPP applications from state nonmember banks and make a recommendation to Treasury on whether a CPP request should be approved or denied.

Controls Over the FDIC’s Processing of Capital Purchase Program Applications from FDIC-Supervised Institutions

Results of Evaluation

As of January 15, 2009, the FDIC had received 1,615 applications from FDIC-supervised institutions requesting almost \$34 billion in TARP funding. The FDIC had recommended 408 applications to Treasury for approval, of which 267 had received awards. FDIC officials estimated that the Corporation will complete its review of the remaining applications during the second quarter of 2009. There are approximately 1,660 additional Subchapter S Corporation and mutual ownership institutions eligible to apply to the CPP. Treasury issued a term sheet for Subchapter S Corporation participation in mid-January 2009.

The FDIC has established controls for reviewing CPP applications that provide reasonable assurance that the Corporation is complying with Treasury’s CPP guidance. The Division of Supervision and Consumer Protection (DSC) issued examination procedures in February 2009 for monitoring compliance with CPP award provisions. Such procedures will allow the FDIC to measure institutions’ success in deploying TARP capital and ensure that the funds are used in a manner consistent with the intent of the Congress.

Compliance with Viability Criteria

DSC officials stressed that the CPP was a Treasury program and that Treasury had developed program parameters, including criteria for assessing applicants’ financial viability. We reviewed 172 applications processed by the FDIC as of December 10, 2008, and determined that 155 of the institutions’ Safety and Soundness (S&S) and Community Reinvestment Act (CRA) ratings and performance ratios met the Treasury viability criteria.

The FDIC considered mitigating factors in reviewing the 17 applications that did not meet Treasury’s criteria. The FDIC forwarded the applications for 13 of the 17 institutions to a CPP Interagency Council for further review, as contemplated by Treasury guidance. However, the FDIC did not forward the four remaining applications not meeting Treasury’s criteria to the CPP Council. The ability of the FDIC, and other federal bank regulators, to consider mitigating factors when making application decisions adds discretion to the process and inherently increases the risk of inconsistency. The use of secondary review panels such as the CPP Council helps to address that additional risk.

We also evaluated reasons for application withdrawals and concluded that 58 percent of the 57 banks that had withdrawn as of December 10, 2008 withdrew voluntarily. The regional offices suggested that the remaining 24 banks withdraw. As of January 15, 2009, 127 institutions had withdrawn from CPP consideration.



Background and Purpose of Evaluation (continued)

In January 2009, the FDIC's Chief Operating Officer testified before the Committee on Financial Services, U.S. House of Representatives, and stated that it is essential for institutions to account for how federal funds (from programs such as the TARP CPP and the Temporary Liquidity Guarantee Program) are being utilized. The testimony noted that the federal bank regulators expect banks to actively seek ways to use CPP assistance by making sound loans to household and business borrowers.

The objective of the evaluation was to assess the FDIC's process and controls associated with reviewing applications from FDIC-supervised institutions to participate in the TARP Capital Purchase Program and forwarding approval recommendations to Treasury.

To view the full report, go to www.fdicig.gov/2009report.asp

Controls Over the FDIC's Processing of Capital Purchase Program Applications from FDIC-Supervised Institutions

Results of Evaluation (continued)

Composition/Characteristics of Applicants Recommended for Approval

For the institutions that the FDIC recommended to Treasury for approval, most had a composite "2" S&S rating and satisfactory CRA rating as shown in the table.

Examination	1	2	3
S&S Composite Rating	19% (77)	76% (312)	5% (19)
S&S Capital Rating	35% (142)	64% (260)	1% (6)
Compliance Rating	25% (42)	68% (113)	7% (12)
	Outstanding	Satisfactory	Needs Improvement
CRA Rating	14% (24)	85% (143)	1% (2)

Note – S&S ratings based on 408 institutions as of January 15, 2009. Compliance and CRA ratings based on our detailed sample of 172 institutions as of December 10, 2008. We could not determine Compliance or CRA ratings for 5 and 3 applicants, respectively.

We determined that about 15 percent of the 408 institutions had some form of S&S or compliance enforcement action outstanding—34 bank board resolutions, 23 memoranda of understanding, and 3 cease and desist orders.

Applicants' Proposed Use of CPP Funds

DSC officials initially noted that Treasury did not specify limits on institutions' use of CPP funds and indicated that the FDIC did not intend to track applicants' use of funds. CPP application forms developed by Treasury also did not require applicants to state their intended use of CPP funds. The FDIC advised state nonmember banks that they could use the CPP to bolster capital or to support acquisitions, both of which could ultimately allow for prudent lending.

In mid-January 2009, the FDIC issued a Financial Institution Letter to state nonmember banks that it expected institutions to monitor the use of CPP funds and show how participation in the CPP would expand prudent lending activity, such as through a plan with definable metrics for measuring performance.

Based on our review of 172 applications, about 44 percent of applicants indicated proposed uses for CPP funds. The most common stated uses of CPP funds were to increase lending, bolster capital, or acquire other institutions.

Recommendations and Other Matters

We made two recommendations to enhance controls over the CPP application review process related to (1) forwarding applications recommended for approval that do not meet one or more of Treasury's criteria to the CPP Council for additional review and (2) requiring Washington Office review of institutions recommended for withdrawal when the institutions technically meet the Treasury criteria. DSC concurred with both recommendations and proposed actions that were responsive to our recommendations.

We also plan to report separately to DSC other matters that were not specifically related to our evaluation objective.

TABLE OF CONTENTS

EVALUATION OBJECTIVE AND APPROACH	1
BACKGROUND	2
EVALUATION RESULTS	3
Status of the FDIC’s Efforts to Process CPP Applications	3
Application Review Process and Internal Controls in Place	4
FDIC Compliance with Treasury Viability Criteria	8
Evaluation of Reasons for CPP Applicant Withdrawals	9
Characteristics of Applicants Recommended for Approval	10
Applicants’ Proposed Use of CPP Funds	14
OVERALL CONCLUSIONS AND RECOMMENDATIONS	16
OTHER MATTERS	16
APPENDIX I: Objective, Scope, and Methodology	17
APPENDIX II: Corporation Comments	18
APPENDIX III: Management Responses to Recommendations	19
TABLES	
Table 1: Status of CPP Application Review and Award	3
Table 2: Status of CPP Application Review and Award by Ownership Structure	3
Table 3: Mitigating Factors for Applicants Not Meeting Treasury Criteria	8
Table 4: Analysis of Reasons for Applicant Withdrawals	9
Table 5: Composite “3-Rated” CPP Applicants Not Meeting Treasury Criteria	11
Table 6: CPP Applicants Forwarded to Treasury with a Capital Component Rating of “3”	12
Table 7: OIG Analysis of Enforcement Actions	13
Table 8: Most Common Stated Uses of TARP CPP Funds	15
FIGURES	
Figure 1: Overview of the CPP Application Review Process	2
Figure 2: S&S Composite Ratings	10
Figure 3: Capital Component Ratings	11
Figure 4: CRA Ratings	12
Figure 5: Compliance Examination Ratings	13



DATE: March 20, 2009

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

FROM: Stephen M. Beard
Assistant Inspector General for Evaluations and Management

SUBJECT: *Controls Over the FDIC's Processing of Capital Purchase Program Applications from FDIC-Supervised Institutions*
(Report No. EVAL-09-004)

This report presents the results of the subject evaluation. The Troubled Assets Relief Program (TARP) Capital Purchase Program (CPP) authorizes the Department of the Treasury (Treasury) to purchase up to \$250 billion of senior preferred shares from qualifying institutions. The federal banking agencies, including the FDIC, are responsible for receiving and reviewing CPP applications from their constituent institutions and making a recommendation to Treasury on whether CPP requests should be approved or denied. As of January 15, 2009, the FDIC had received applications from 1,615 institutions totaling almost \$34 billion in award requests.

EVALUATION OBJECTIVE AND APPROACH

The objective of the evaluation was to assess the FDIC's process and controls associated with reviewing applications from FDIC-supervised institutions to participate in the TARP CPP and forwarding approval recommendations to Treasury.

To accomplish our objective, we interviewed headquarters and regional Division of Supervision and Consumer Protection (DSC) officials involved in reviewing applications and making award recommendations to Treasury. We also evaluated case decision memoranda and supporting application documentation for applications to ensure that applicants met Treasury's viability criteria. Finally, we compiled summary information regarding the supervisory characteristics of institutions recommended for CPP funding and, where disclosed, recipient institutions' proposed usage of CPP funds. We performed detailed testing on applications forwarded to Treasury as of December 10, 2008 and evaluated application review activity as of January 15, 2009.

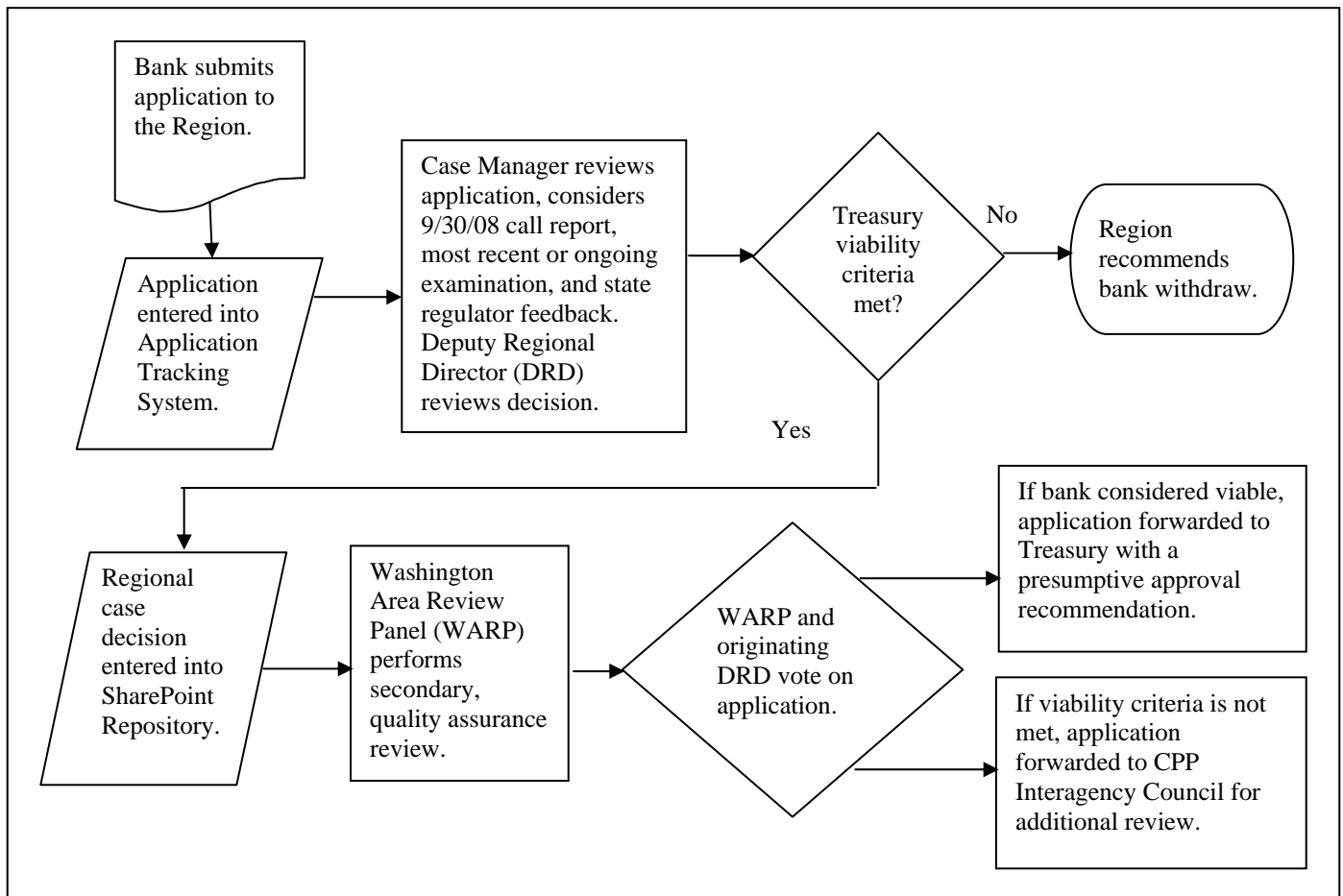
We performed our evaluation during December 2008 and January 2009 in accordance with the *Quality Standards for Inspections*. Details on our objective, scope, and methodology are provided in Appendix I.

BACKGROUND

In October 2008, the Congress passed and the President signed the Emergency Economic Stabilization Act of 2008 (EESA). The Act provides authority for the Federal Government to purchase certain types of troubled assets for purposes of providing stability to the economy and the nation’s financial system. The Act established the Office of Financial Stability within Treasury and authorized the TARP. Under the TARP, Treasury will purchase up to \$250 billion of preferred stock through the CPP. The CPP is available to qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies. Treasury will determine eligibility and allocations for interested parties after consultation with the appropriate federal banking agency. Specifically, in the case of the FDIC, the Corporation will analyze CPP applications from state nonmember banks and make a recommendation to Treasury on whether a CPP request should be approved or denied.

DSC is responsible for CPP at the FDIC. DSC regional offices are performing the application review. Figure 1 provides an overview of the application review process.

Figure 1: Overview of the CPP Application Review Process



Source: OIG review of DSC and Treasury CPP information.

EVALUATION RESULTS

Status of the FDIC's Efforts to Process CPP Applications

As of January 15, 2009, the FDIC had received 1,615 applications from FDIC-supervised institutions requesting almost \$34 billion in TARP funding. The FDIC had recommended 408 applications to Treasury for approval, of which 267 had received awards as shown in Table 1.

Table 1: Status of CPP Application Review and Award (dollars in millions)

Region	Applications Received		Applications Forwarded to Treasury		Applications Approved by Treasury	
	Applicants	Amount Requested	Applicants	Amount Requested	Applicants	Amount Received
Atlanta	345	\$9,006	76	\$6,450	61	\$6,313
Chicago	295	\$2,617	29	\$767	19	\$395
Dallas	242	\$2,719	66	\$1,029	27	\$716
Kansas City	283	\$1,894	73	\$726	33	\$502
New York	204	\$11,468	79	\$4,674	58	\$3,039
San Francisco	246	\$6,262	85	\$3,114	69	\$2,672
Total	1,615	\$33,966	408	\$16,760	267	\$13,637

Source: OIG Analysis of FDIC CPP National Daily Report dated January 15, 2009.

FDIC officials indicated that Treasury instructed the federal banking agencies to process the publicly traded applicants first, followed by privately held corporations. DSC officials indicated that there were approximately 1,660 additional Subchapter S Corporations and mutual FDIC-supervised institutions that could apply to the CPP once Treasury issues term sheets for participation.¹ Table 2 presents application status information by the ownership structure of the applicants as of January 15, 2009.

Table 2: Status of CPP Application Review and Award by Ownership Structure

Ownership Structure	Applications Received		Applications Forwarded to Treasury		Applications Approved by Treasury	
	Applicants	Amount Requested	Applicants	Amount Requested	Applicants	Amount Requested
Publicly Traded Stock	321	\$17,580	196	\$14,805	176	\$12,567
Private Corporation (not publicly traded)	851	\$13,169	206	\$1,883	89	\$1,056
Private S Corp	365	\$2,263	2	\$8	0	\$0
Mutual	45	\$576	0	\$0	0	\$0
Other*	33	\$378	4	\$64	1	\$14
	1,615	\$33,966	408	\$16,760	267	\$13,637

Source: OIG Analysis of January 15, 2009, Application Tracking System (ATS) information.

* ATS did not specify ownership type information for 18 institutions.

On average, DSC regional offices are taking 16 calendar days from the time an application is received to review the application and forward the case decision to the FDIC Washington Area Review Panel (WARP). The WARP is taking an average of 17 additional days to complete its

¹ Treasury issued a CPP term sheet for Subchapter S Corporations on January 14, 2009.

review and forward applications to Treasury. For the 267 applications approved by Treasury, it took Treasury, on average, 7 days to notify the FDIC that the applicant had been approved for CPP participation. The remaining 141 FDIC-submitted applications awaiting Treasury approval, as of January 15, 2009, had been at Treasury for an average of 11 days. DSC officials estimated that the FDIC will complete its review of the remaining applications in the second quarter 2009.

Application Review Process and Internal Controls in Place

The FDIC has established controls to provide reasonable assurance that the Corporation complies with Treasury's CPP guidance and to guide DSC's review of CPP applications. The FDIC's process for reviewing applications is consistent with guidance issued by Treasury. DSC also issued examination procedures that should enable the FDIC to measure participating institutions' success in deploying TARP capital and ensure that the funds are used in a manner consistent with the intent of Congress.

Program Guidance to the Banking Industry and Examiners: The FDIC has issued guidance to state non-member institutions in the form of Financial Institution Letters (FIL), as follows:

- FIL-128-2008, November 12, 2008, *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*, which encouraged institutions to lend prudently and responsibly to creditworthy borrowers; work with borrowers to preserve homeownership and avoid preventable foreclosures; adjust dividend policies to preserve capital and lending capacity; and employ compensation structures that encourage prudent lending;
- FIL-109-2008, dated October 20, 2008, *Applications to the Troubled Asset Relief Program's Capital Purchase Program*, which encouraged state nonmember institutions to participate in the TARP CPP to strengthen their capital positions and ability to prudently make credit available in their lending markets. The FIL also summarized the application process; and
- FIL-1-2009, dated January 12, 2009, *Monitoring the Use of Funding from Federal Financial Stability and Guaranty Programs*, which stated that state nonmember institutions should implement a process to monitor their use of capital injections, liquidity support, and/or financing guarantees obtained through recent financial stability programs established by the Treasury, FDIC, and Federal Reserve.

On February 9, 2009, DSC issued Regional Director Memorandum 6300, *Examination Guidance for Financial Institutions Receiving Subscriptions from the U.S. Department of the Treasury's TARP CPP Program*, to provide examiners with work steps for assessing compliance efforts of institutions participating in the CPP and for assessing how institutions are incorporating the interagency statement on responsible lending into their lending operations.

Organizational Structure and Resources: On October 31, 2008, the FDIC Board delegated authority to the Director, DSC, to recommend to Treasury approval or denial of applications by state nonmember institutions to participate in the TARP CPP. This delegation required that recommendations regarding applications by institutions with total assets greater than \$500 million and that do not meet Treasury's CPP criteria for presumptive acceptance will

require a recommendation from DSC that must be approved by the Chairman. The Board also provided the Director, DSC, authority to recommend to Federal Reserve districts approval or denial of CPP applications filed by bank holding companies in cases where the largest insured depository institution is a state nonmember institution.

DSC has developed regional and Washington Office governance structures for implementing the CPP and has assigned regional and headquarters resources to the effort. The regions have more than 110 staff working on CPP applications. For the most part, the regional case managers review applications from those institutions that the case manager routinely oversees. As discussed later, most regions have also identified a regional coordinator or facilitator for the CPP effort. The Deputy Regional Director reviews and approves case manager recommendations for all applications. In some regions, Assistant Regional Directors may receive informational copies of case decision memoranda or may review the case manager's decision.

DSC headquarters has about 20 staff working on the CPP, including three senior officials who serve on the WARP. The WARP performs a secondary review of all regional office recommendations. DSC's Associate Director, Risk Management Policy Branch, is managing the overall CPP application review effort for the FDIC and is the FDIC's representative on the CPP Interagency Council (CPP Council).

Procedures and Processing Guidelines: In addition to the FILs, mentioned earlier, DSC's Washington Office issued the *RO Processing Guidelines for TARP Capital Purchase Program*, in October 2008. This document:

- provides background for the TARP and CPP;
- describes the FDIC's role;
- suggests regional office application review steps and time frames for application reviews;
- explains the process for reviewing borderline, or marginally-suited applications; and
- explains Washington Office work steps.

The guidelines note that applications should be processed within 5 business days after acceptance and then transmitted to the Washington Office.

Treasury Viability Criteria and Additional Treasury Guidance: On October 20, 2008, Treasury issued final viability criteria for the federal banking agencies to use in reviewing CPP applications. Treasury has not issued the viability criteria publicly. The Treasury viability criteria states that the CPP eligibility recommendation will be based on an assessment of the overall strength and viability of the applicant without considering potential funds received under the CPP. Treasury presents criteria for classifying applications as either recommended for approval, disapproval, or for additional review by the CPP Council. The viability criteria is based on the institution's examination ratings and selected performance ratios.² We confirmed

² Because Treasury has not issued the viability criteria publicly, we are not discussing the specific performance ratios that the federal banking agencies use to review CPP applications in this report. Our discussion of the Treasury viability criteria is consistent with the Government Accountability Office's description of the program in its December 2008 report, *Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability and Transparency*, GAO-09-161.

that DSC used the Treasury viability criteria in assessing CPP applications from FDIC-supervised institutions.

We also confirmed that the FDIC utilized other Treasury-issued guidance and documents, such as the Treasury-issued *TARP Capital Purchase Program Case Decision Memo*. This 2-page document records the application review findings related to CAMELS and CRA ratings and selected performance ratios; includes an area for recording narrative comments related to the federal banking agency recommendation; and requests a brief summary of the viability assessment, supervisory strategy, and any material or relevant enforcement actions.

DSC officials indicated that Treasury has issued additional informal guidance by e-mail based on Treasury's review of some of the earlier CPP applications. DSC has incorporated this additional informal guidance into its application review process.

Case Management Systems and Application Repository: The Dallas Regional Office Management Information Group (ROMIG) developed a MicroSoft Access[®]-based database for tracking information about CPP applications. Each regional office uses this Application Tracking System (ATS). ATS includes an individual institution "look-up" feature that presents detailed information about an applicant, including bank points of contact, capital ratios, and performance ratios. ATS also includes a reporting facility that is used to prepare the TARP CCP application activity report, which is discussed in more detail below.

DSC also developed a SharePoint[®] site that serves as a repository for case materials for applications forwarded by the regions to the Washington Office. DSC establishes a record for each applicant that includes an electronically scanned version of the institution's CPP application, the case decision memorandum, a WARP quality assurance review form, and supporting documentation for the application from the case manager.³

The SharePoint[®] site organizes applications based on their process stage (e.g., by region, Washington Office, or pending review by Treasury). SharePoint[®] also includes a library of CPP policy and procedural documents.

Supervisory Review and Quality Assurance Processes: DSC has built in a number of levels of supervisory review of award recommendations and quality assurance controls at the regional and Washington Office level. In most of the regions, an Assistant Regional Director and the Deputy Regional Director (DRD) review the case decision memorandum. In addition, the WARP and DRD from the originating region review the regional recommendation and verify that the regional conclusions are well-reasoned and defensible.

The only exception to this supervisory review process is for applications that are withdrawn at the regional level. If the region suggests that an institution withdraw its application, that recommendation or decision is not reviewed by the Washington Office. As discussed earlier, DSC has delegated this responsibility to the regional offices.

³ Applications for institutions that voluntarily withdraw or institutions for which a region informally recommends withdrawal are not entered into the SharePoint[®] repository. DSC does record within the ATS whether an applicant has withdrawn and the withdrawal date.

With respect to quality assurance, most of the regions have assigned a case manager to serve as a regional CPP facilitator to ensure that Washington Office and Treasury guidance is disseminated, ensure that case decision memoranda are complete, monitor regional progress in reviewing applications, and compile any regional CPP reporting information or statistics.

Status Reporting to the FDIC Board and Chief Operating Officer: DSC is utilizing the ATS to produce a weekly activity status report of CPP application review activity for the FDIC Board of Directors and the Chief Operating Officer (COO). This report includes information such as:

- Institution-specific information such as bank name, total assets, and ownership structure;
- Application tracking information such as date the application was received by the FDIC and date that the application was sent to Treasury;
- The amount of CPP funding requested and as a percentage of risk-weighted assets; and
- The institutions' CAMELS ratings, most recent examination date, and whether the bank has any enforcement actions outstanding.

This report is beneficial in assessing DSC progress in reviewing applications, the number of applicants that have withdrawn from consideration, and the number and amount of Treasury awards.

Examination Procedures for Monitoring Compliance with Award Provisions: As discussed earlier, DSC issued Regional Director Memorandum 6300, *Examination Guidance for Financial Institutions Receiving Subscriptions from the U.S. Department of the Treasury's TARP CPP Program*, in February 2009, which provided examination work steps for:

- Ensuring recipients comply with TARP CPP securities purchase agreements by reviewing:
 - Employment contracts with the institution's top five executives,
 - Executive compensation practices against the principles of EESA Sec. 111(b),
 - Cash dividends in relation to pre-TARP dividends, and
 - The institution's capital structure to ensure that equity has not been retired.
- Understanding how recipients made use of TARP CPP funds and considering recipients' success in achieving the goals of the November 2008 interagency statement on meeting the needs of creditworthy borrowers by:
 - Determining the impact from receipt of TARP CPP monies, including referencing Call Report data, internal bank lending reports, and new loan/pipeline reports;
 - Evaluating the institution's support of market credit needs since receiving CPP funding;
 - Determining whether proceeds were down-streamed to the bank or used at the holding company or non-bank affiliates;
 - Evaluating the institution's foreclosure prevention and loan modification efforts, such as efforts to increase lending and prevent foreclosures over the payment of dividends; and
 - If the institution used TARP CPP monies to fund an acquisition, evaluating whether this has resulted in increased lending in the merged institution's market area.

The examination procedures should help the FDIC measure participants' success in deploying TARP capital and ensure that funds are used in a manner consistent with the Congress' intent.

FDIC Compliance with Treasury Viability Criteria

As discussed earlier, Treasury has established viability criteria for the banking agencies' use in making a CPP recommendation. DSC officials stressed that the CPP was a Treasury program and that Treasury had developed parameters for the program, including criteria for assessing an applicant's financial viability. Treasury guidance indicates that the banking agency should forward applicants with unacceptable performance ratios to the CPP Council for review. Treasury also presented several mitigating factors that the banking agencies could consider in making application recommendations.

We reviewed the case decision memoranda and supporting application documentation for each of the 172 institutions, as of December 10, 2008, for which the FDIC had recommended presumptive approval to Treasury or for further review by the CPP Council. We verified that most of the 172 institutions met the Treasury criteria. Seventeen of the 172 institutions (10 percent) did not meet at least one of the Treasury viability criteria. However, we verified that in each of the 17 cases, the FDIC case decision memorandum discussed mitigating factors. As of February 11, 2009, Treasury had approved 13 of the 17 cases and one institution had withdrawn. Table 3 presents additional information about the 17 cases and mitigating factors.

Table 3: Mitigating Factors for Applicants Not Meeting Treasury Criteria

Bank	Criteria Not Met	Forwarded to Council?	Mitigating Factors
1	Performance Ratio*	Yes	Bank raised \$600 million in capital and committed to raising \$300 million more.
2	CRA Rating	Yes	CRA rating at ongoing examination improved to Outstanding.
3	Two Performance Ratios	Yes	Bank has identified and adequately reserved for problem loans.
4	Two Performance Ratios*	Yes	Capital ratios are solid. Holding company injected capital.
5	Performance Ratio*	No	Overall condition is sound. Adequate risk management practices and oversight for loan concentration risks.
6	Performance Ratio	Yes	Historically 1 or 2-rated. Favorable management.
7	Performance Ratio	Yes	Discontinued construction and development (C&D) loan growth. Bank well-capitalized with positive earnings and adequate risk management.
8	Performance Ratio	Yes	Bank well-capitalized. Acceptable risk management. Bank management has targeted a reduction in C&D loans.
9	Two Performance Ratios*	No	Capital levels adequate and earnings are sufficient.
10	Two Performance Ratios	Yes	Suffered losses on Government Sponsored Enterprise stock.
11	Two Performance Ratios*	Yes	Historically 1-rated. President/CEO replaced. Board/management responsive and addressing asset quality.
12	CRA Rating	No	Bank adopted a CRA action plan and had made progress.
13	Two Performance Ratios	Yes	Capital injection from parent. Bank selling non-performing loans. New bank management.
14	Two Performance Ratios	Yes	Management proactive in reducing problem assets and making progress in addressing examination deficiencies.
15	Performance Ratio	No	Historically well-rated. Well-capitalized.
16	Three Performance Ratios	Yes	Historically 1-rated. Deterioration due to a residential construction lending program that has been discontinued.
17	Four Performance Ratios	Yes	Bank complying with a state supervisory action. Bank obtaining additional \$30 million investment.

Source: OIG Review of Case Decision Memoranda and Supporting Documentation.

* Bank performance ratio was within 10 percentage points of Treasury performance criteria.

As shown above, in 13 of the 17 cases involving mitigating factors, the FDIC forwarded the case decision memorandum to the CPP Council for additional review as contemplated in Treasury’s guidance. However, the FDIC did not forward four of the applications not meeting Treasury’s criteria to the CPP Council. The ability of the FDIC, and other federal bank regulators, to consider mitigating factors when making application decisions adds discretion to the process and inherently increases the risk of inconsistency. The use of secondary review panels such as the WARP and CPP Council helps to address that additional risk. Accordingly, we recommended that DSC reiterate to regional officials that all applicants being recommended to the Treasury for approval that do not meet one or more of the Treasury viability criteria be forwarded to the CPP Council for further review.

Evaluation of Reasons for CPP Applicant Withdrawals

We also evaluated reasons for application withdrawals and concluded that a little more than one-half of the 57 banks that had withdrawn as of December 10, 2008 withdrew voluntarily. DSC officials indicated that it was rare for a federal banking agency or Treasury to formally deny a CPP application because the decision becomes public and could negatively impact the public’s perception of the institution. Instead, the banking agencies or Treasury encourage institutions that do not meet the viability criteria to informally withdraw their application. Institutions may withdraw voluntarily because they are no longer interested in participating in the CPP or may withdraw based on the FDIC’s suggestion that they do not meet the criteria for a presumptive recommendation for approval.

We asked the regional offices to provide information about the circumstances for withdrawals for the 57 banks that had withdrawn as of December 10, 2008. Table 4 presents information about withdrawal activity and reasons for the FDIC suggesting that applicants withdraw.

Table 4: Analysis of Reasons for Applicant Withdrawals

Region	Voluntarily Withdrew	FDIC Suggested Bank Withdraw	Reasons for FDIC Suggesting Withdrawal
Atlanta	4	1	State member bank filed in error with the FDIC.
Chicago	5	2	CAMELS “4” and “5-rated” banks.
Dallas	10	1	Not a Qualified Financial Institution.
Kansas City	4	10	Nine were CAMELS “4-” or “5-rated” banks. One had a proposed “4 rating.”
New York	4	0	All withdrew voluntarily.
San Francisco	6	10	Six were “4” or “5-rated” or significantly deteriorating. Bank not eligible due to foreign ownership. Three technically met criteria. (Discussed further below.)
Total	33	24	

Source: OIG Review of Case Decision Memoranda.

According to case decision information in the ATS, three institutions that the San Francisco Regional Office suggested withdraw from consideration were well-capitalized and technically met the Treasury performance ratio criteria. We followed up with regional management who indicated that, in all three cases, poor bank management was the region’s primary concern in recommending that the three institutions withdraw. We also noted that case decision memoranda

for the three institutions identified concerns related to liquidity, asset quality, and enforcement action activity.

As discussed earlier, the use of mitigating factors--in these cases to recommend that applicants withdraw from consideration--increases the risk of inconsistency. We recommended that in cases where an applicant technically meets the Treasury criteria, but the regional office concludes that the applicant is not a viable candidate for CPP funding, that the region forward the application to the Washington Office for review.

During a January 13, 2009 Risk Analysis Center presentation, a DSC official indicated that the number of withdrawals had increased to 112 and that a number of banks had voluntarily withdrawn as a result of the additional monitoring measures and conditions on the use of TARP funds proposed by the Chairman of the House Financial Services Committee. As of January 15, 2009, 127 institutions had withdrawn.

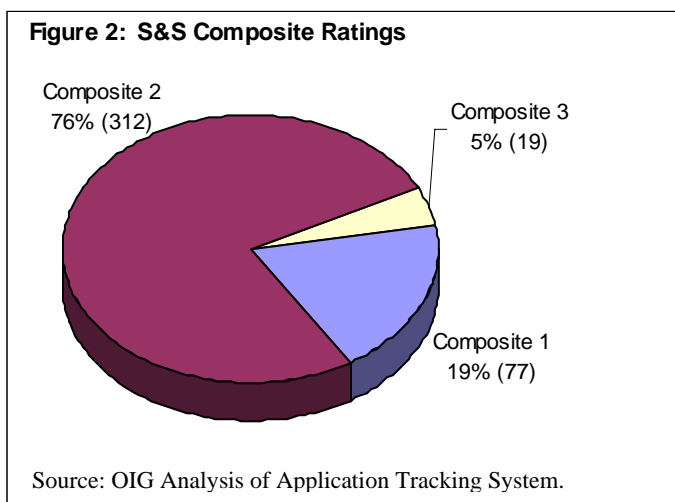
Characteristics of Applicants Recommended for Approval

Most of the 408 institutions that the FDIC had recommended to Treasury for CPP approval as of January 15, 2009, had a composite “2” rating and Capital component rating of “2” at their most recent safety and soundness (S&S) examination. Most of the 172 institutions in our detailed sample had a “2” compliance examination rating and a “satisfactory” CRA rating. About 15 percent of the 408 institutions (59 institutions) had some form of enforcement action.

S&S Composite Ratings: We reviewed the CPP National Daily Report as of January 15, 2009 to understand the composition of the S&S composite ratings for the 408 institutions that the FDIC had forwarded to Treasury for approval or the CPP Council for further review.

According to information within the ATS, approximately 76 percent of the institutions received a composite 2 rating at their most recent S&S examination. Figure 2 presents composite rating information for the 408 institutions.

We reviewed the case decision memoranda and supporting documentation for the 19 composite “3-rated” institutions. We confirmed that 14 of the 19 applications met the Treasury performance ratio criteria.⁴ The remaining five Composite “3-rated” applications were either not “well capitalized” or did not meet one of the Treasury performance ratios, as shown in Table 5.



⁴ Though technically not required to do so, the FDIC forwarded 4 of the 14 applications to the CPP Council for consideration rather than recommending them for presumptive approval.

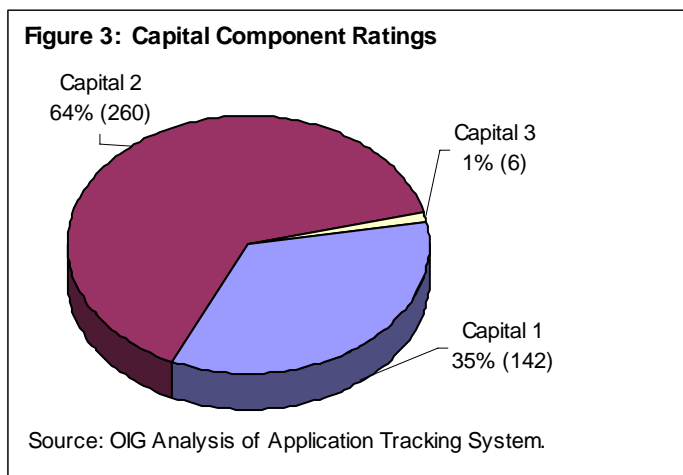
Table 5: Composite “3-Rated” CPP Applicants Not Meeting Treasury Criteria

Institution	CPP Subscription Amount (in 000s)	Meets “Well Capitalized” Capital Requirements?	Meets Treasury Viability Performance Ratios?	Application Forwarded to CPP Council?	Criteria Not Met
1	\$30,900	Yes	No	Yes	One Performance Ratio
2	\$182,900	Yes	No	Yes	One Performance Ratio
3	\$73,700	Yes	No	Yes	Two Performance Ratios
4	\$17,000	No	Yes	No, not required	One Performance Ratio
5	\$57,000	No	No	Yes	Three Performance Ratios

Source: OIG Analysis of the January 15, 2008 CPP National Daily Report and Application Tracking System.

We also noted that three institutions’ composite ratings were downgraded following the FDIC’s submission of the application to the CPP Council, but before Treasury made a CPP award decision. We determined that in each case, the regional office notified the Washington Office, which notified Treasury of the ratings changes. Two of the banks subsequently withdrew. FDIC officials provided other examples of ratings changes or applicant deterioration information that the FDIC communicated to Treasury.

S&S “Capital” Component Ratings: We reviewed the CPP National Daily Report as of January 15, 2009 to understand the composition of the S&S Capital component rating for the 408 institutions that the FDIC had forwarded to Treasury for approval or to the CPP Council for further review. Approximately 64 percent of the institutions received a Capital component rating of “2” at their most recent S&S examination, as shown in Figure 3.



Six institutions had a Capital component rating of “3.” FDIC’s *Risk Management Manual of Examination Policies* provides that a Capital component rating of “3” indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements. We reviewed supporting documentation for the six institutions with Capital component “3” ratings as shown in Table 6.

Table 6: CPP Applicants Forwarded to Treasury with a Capital Component Rating of “3”

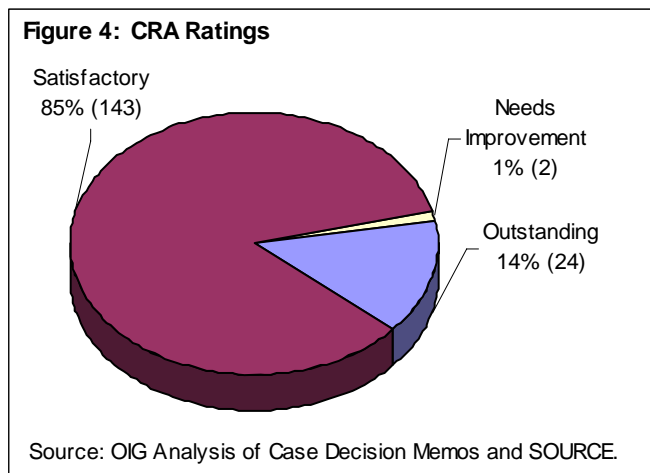
Institution	CPP Subscription Amount (in 000s)	Meets “Well Capitalized” Capital Requirements?	Meets Treasury Viability Performance Ratios?	Application Forwarded to CPP Council?	Criteria Not Met
1	\$570,000	Yes	Yes	Yes, not required	Met Criteria
2	\$73,700	Yes	No	Yes	Two Performance Ratios
3	\$450	Yes	Yes	No, not required	Met Criteria
4	\$135,000	Yes	Yes	No, not required	Met Criteria
5	\$57,000	Yes	No	Yes	Two Performance Ratios
6	\$11,500	Yes	Yes	Yes, not required	Met Criteria

Source: OIG Analysis of the January 15, 2008 CPP National Daily Report and Application Tracking System.

We confirmed that the FDIC submitted institutions 2 and 5 to the CPP Council for further review, as required. Institutions 2 and 5 were well-capitalized, but did not meet all of Treasury’s CPP viability performance ratios. As of February 11, 2009, Treasury had remanded both institutions back to the FDIC for additional support on the institutions’ viability.

Community Reinvestment Act (CRA) Ratings: As discussed earlier, an applicant’s CRA rating is another factor that Treasury instructed the federal banking agencies to consider in making award recommendations. We reviewed the CRA ratings for the 172 institutions in our detailed review sample as of December 10, 2008.⁵ According to information within the case decision memoranda, approximately 85 percent of the institutions received a Satisfactory rating and 14 percent Outstanding in their most recent CRA examination as shown in Figure 4.⁶

We also reviewed CRA information for the two institutions with “Needs Improvement” CRA ratings. Case decision memoranda and supporting documentation indicated that in one case the institution was making progress in responding to a CRA-related enforcement action. In the second case, an on-going CRA examination preliminarily concluded that the institution had improved to “Outstanding.” We also noted that one Atlanta region CPP applicant withdrew from consideration based on historical CRA and other compliance issues.

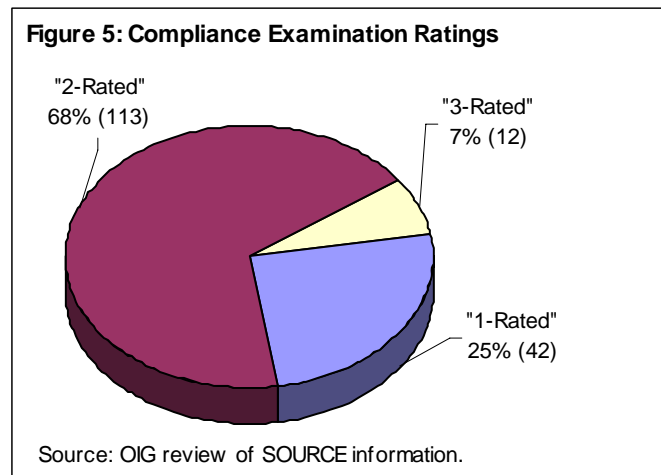


⁵ DSC maintains CRA and Compliance examination information in its System of Uniform Reporting of Compliance and CRA Examinations (SOURCE).

⁶ CRA rating information was not available for 3 institutions who were new to FDIC regulation either as *de novo* institutions or through a bank charter change.

Compliance Examination Ratings: While not a Treasury criteria, we confirmed that each of the regions were factoring applicants' compliance ratings into CPP recommendation decisions. We verified that each region's case managers performing the application reviews coordinated with the region's compliance examination staff or reviewed SOURCE information to verify the institution's compliance position and CRA rating. We verified compliance ratings for the institutions in our detailed sample as shown in Figure 5.⁷

Twelve institutions had a compliance rating of "3" which means that, generally, the institution is in a less than satisfactory compliance position. A "3-rating" is generally a cause for supervisory concern and requires more than normal supervision to remedy deficiencies.



Enforcement Actions: We also reviewed the 172 institutions for evidence of S&S or compliance enforcement actions. The CPP National Daily Report indicated that 33 institutions recommended for presumptive approval had outstanding formal or informal enforcement actions. Representatives from each region also stated that, when reviewing an application, case managers review the Formal and Informal Action Tracking (FIAT) System to determine whether the applicant is under any existing or pending enforcement actions, including compliance enforcement actions related to fair lending or unfair and deceptive acts or practices (UDAP).⁸ We researched the nature of each enforcement action as presented in Table 7.

Table 7: OIG Analysis of Enforcement Actions

Type of Action	S&S or Bank Secrecy Act-Related	Compliance-Related
Bank Board Resolution (BBR)	11 Institutions Asset quality and earnings issues Liquidity and market sensitivity	5 Institutions Compliance Management System (CMS) weaknesses UDAP compliance for third-party servicers Truth in Lending Act and Real Estate Settlement Procedures Act issues
Memorandum of Understanding (MOU)	9 Institutions Asset quality and poor earnings Capital maintenance BSA issues Credit concentrations ALLL methodology	9 Institutions CMS weaknesses and compliance training Truth in Lending Act with civil monetary penalties Home Mortgage Disclosure Act violations Fair Credit Reporting Act issues Flood insurance violations
Cease & Desist Order (C&D)	1 Institution Capital restoration, restrictions on asset growth, limits on dividends and executive compensation	1 Institution Substantive violations of the Federal Trade Commission Act and Equal Credit Opportunity Act

Source: OIG Review of the DSC's Formal and Informal Action Tracking System

Note: Several institutions had multiple enforcement actions.

⁷ We could not determine compliance ratings for 5 of the 172 institutions in our sample.

⁸ Treasury considers enforcement actions in making CPP award decisions. However, an enforcement action does not necessarily disqualify an applicant from CPP consideration.

As of January 15, 2009, the 408 institutions recommended for approval or further review collectively had 34 BBRs, 23 MOUs, and 3 C&Ds.

We confirmed that the regional offices do not coordinate with FDIC's Legal Division regarding whether CPP applicants are subject to any enforcement or legal action. DSC regional officials indicated that DSC usually initiates enforcement actions and thus would be aware of an applicant's enforcement action history. Although we believe that some coordination with the Legal Division would be prudent, we acknowledge that the possibility of DSC not being aware of an enforcement action is remote. Accordingly, we are not making a formal recommendation in this regard. However, we would suggest that DSC be open to identifying non-burdensome forms of coordination with the Legal Division to ensure that CPP applicants recommended for approval do not have historical or pending predatory lending or consumer-related enforcement actions that could be potentially embarrassing for the Corporation.⁹

Applicants' Proposed Use of CPP Funds

DSC officials initially told us that Treasury did not specify limits on institutions' use of CPP funds and indicated that the FDIC did not intend to track applicants' use of funds. FDIC officials stressed that the CPP was Treasury's program and noted that CPP application forms developed by Treasury did not require applicants to state their intended use of CPP funds.

However, we did note that in its initial announcement of the program, the FDIC advised that state nonmember banks could use the CPP to bolster capital or to support acquisitions of other institutions. Specifically, FIL-109-2008, stated: "Participation in this low-cost capital program can bolster financial strength, or potentially support acquisitions, both of which ultimately allow for prudent lending that may currently be constrained by capital levels."

DSC officials initially told us that money is fungible and that it would be difficult for examiners to track for what purpose state nonmember institutions used CPP awards, especially in situations where an institution received capital contributions from other, non-TARP sources.

DSC representatives from most of the regions told us that they did inquire about applicants' proposed use of CPP funds. One regional representative told us that while it might not be possible to track "dollar-for-dollar" how CPP funds were used, it should be relatively easy for examiners to detect whether a TARP recipient had increased business and consumer lending. At least one regional DSC representative also defended institutions' practice of using CPP funding to bolster capital and noted that shoring-up an institution's capital position was a means to an end that would place an institution in a more solid position to lend responsibly.

Based on our review of 172 applications, about 44 percent of the applicants (76 institutions) indicated proposed uses for CPP funds despite not being required to do so. In most of those cases, the applicant stated it intended to use funds to bolster capital, increase lending, or acquire other institutions. Table 8 presents the most common reasons stated.

⁹ Although remote, it is possible that regional management may not be aware of an action brought against an institution by another federal agency, such as a UDAP violation or action brought by the Federal Trade Commission.

Table 8: Most Common Stated Uses of TARP CPP Funds

Proposed Use of Funds	Number of Institutions Stating Proposed Use*
Increase responsible lending to consumers	49
Increase or preserve capital	26
Acquire other institutions	22
Fund subsidiary bank	11
Support bank growth or strengthen balance sheet	9
Enhance or increase liquidity	9

Source: OIG review of 172 CPP Applications as of December 10, 2008.

* Some applicants stated multiple proposed uses of funds.

On January 12, 2009, the FDIC issued FIL-1-2009, *Monitoring the Use of Funding from Federal Financial Stability and Guaranty Programs*, advising insured institutions that they should track their use of capital injections, liquidity support, and/or financing guarantees obtained through recent financial stability programs. The FIL suggested that the tracking would be part of a process for determining how these federal programs have improved the stability of the institution and contributed to lending to the community and providing such information to investors and the public in shareholder reports and financial statements.

On January 13, 2009, the FDIC's COO testified before the Committee on Financial Services, U.S. House of Representatives, on *Use of TARP Funds Under the Emergency Economic Stabilization Act of 2008*. The COO reported that the FDIC was preparing examination guidance for evaluating participating banks' compliance with EESA, the CPP securities purchase agreements, and success in implementing the goals of the November 2008 interagency statement on responsible lending.¹⁰ The COO noted that examiners would be reviewing institutions for the following:

- Establishment of a monitoring process for the use of TARP proceeds to determine the primary uses by the institution of received funds;
- Increased lending efforts in the institution's market since receiving a TARP CPP subscription;
- Down-streaming subscription proceeds to the insured depository institution (if a holding company structure is in place) to ensure that TARP funds can be intermediated into loans and bank capital is augmented;
- Engagement in mortgage loan modification or foreclosure prevention efforts that rely on systematic, proactive approaches that enhance the net present value of individual mortgage loans versus foreclosure;
- Utilization of executive compensation programs that exemplify good corporate governance and conform with EESA and other requirements; and
- Implementation of the goals of the interagency statement to meet the needs of creditworthy borrowers in the institution's market area.

The COO also encouraged the development of a troubled asset program that met three principles of accountability, transparency, and viability. Regarding transparency, the COO noted that

¹⁰ As discussed earlier, the FDIC issued CPP examination procedures in February 2009.

participants in the program should be required at the outset to show how participation would expand prudent lending activity and should provide the government with a plan for using the funds to facilitate new lending, with definable metrics for measuring performance.

OVERALL CONCLUSIONS AND RECOMMENDATIONS

The FDIC is making progress in reviewing CPP applications and making award recommendations to Treasury. The Corporation has established controls to provide reasonable assurance that it complies with Treasury's CPP guidance as it carries out that process. Based on our review, we determined that the FDIC followed the Treasury guidance for substantially all of the applications we reviewed. Finally, DSC has also developed examination procedures that will allow the Corporation to measure participating institutions' success in deploying TARP capital and ensure that the funds are used in a manner consistent with the intent of the Congress.

To further enhance controls over the application review process, we recommend that the Director, DSC:

- (1) Reiterate to regional officials that all applicants being recommended to the Treasury for approval that do not meet one or more of the Treasury viability criteria be forwarded to the CPP Council for further review.
- (2) In instances where an applicant technically meets, or nearly meets, Treasury's viability criteria, but the region recommends that the applicant withdraw because of other concerns, require that such decisions be reviewed by the Washington Office.

CORPORATION COMMENTS AND OIG EVALUATION

DSC management provided a written response, dated March 18, 2009, to a draft of this report. The response is presented in its entirety in Appendix II. Management concurred with both recommendations and proposed actions to be completed by March 27, 2009 that were responsive to both recommendations. A summary of management's responses to our recommendations is presented in Appendix III.

OTHER MATTERS

During our evaluation, we identified other matters that were not specifically related to our evaluation objective. We intend to report separately to DSC on those other matters.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to assess the FDIC's process and controls associated with reviewing applications from FDIC-supervised institutions to participate in the TARP Capital Purchase Program and forwarding approval recommendations to Treasury. To accomplish our objective, we interviewed headquarters and regional DSC officials involved in reviewing applications and making award recommendations to Treasury. We also evaluated case decision memoranda and supporting application documentation to ensure that applicants met Treasury's viability criteria. Finally, we compiled summary information regarding the supervisory characteristics of institutions recommended for CPP funding and, where disclosed, recipient institutions' proposed usage of CPP funds.

We selected a test date of December 10, 2008. The FDIC had recommended 172 applications for approval to Treasury as of that date. We reviewed the case decision memoranda and supporting documentation in the SharePoint® application repository system for all 172 applications. We confirmed that the applications met Treasury's viability criteria. In cases where an applicant did not meet the criteria, we checked for mitigating factors, additional discussion, or consideration by the CPP Council. We also analyzed ATS information as of January 15, 2009 to obtain more recent program status information.

We relied on application information and supporting documentation in the SharePoint® application repository system. We did not independently verify or validate information within the ATS or SharePoint® site with source documents (such as examination reports or call reports). We did not evaluate the merits of individual applications or conclude whether individual applicants should or should have not been recommended for CPP funding.

Specifically, our work included the following:

- Reviewed available Treasury and FDIC guidance on the TARP CPP, including FDIC Financial Institution Letters.
- Reviewed FDIC Washington Office and regional office guidance.
- Reviewed GAO reports issued on the TARP and held discussions with GAO staff to understand their work and their views of legislative intent and intended use of TARP funds.
- Interviewed FDIC Washington officials and regional officials regarding the program and the FDIC's processing of applications.
- Documented and assessed the process for reviewing applications and program controls that the FDIC has put into place.
- Analyzed and compiled summary information on the number of applications received, reviewed, withdrawn, and denied.
- Determined the number of, and reasons for, CPP application withdrawals.
- Assessed the number of, and nature of, applicants' enforcement actions.
- Assessed applicants' use of CPP funding and how the FDIC will monitor compliance with CPP award terms.

We performed our evaluation from December 2008 through January 2009, in accordance with the *Quality Standards for Inspections*.

CORPORATION COMMENTS



Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

March 18, 2009

TO: Stephen M. Beard
Assistant Inspector General for Evaluations and Management

FROM: Sandra L. Thompson
Director

SUBJECT: Response to Draft Evaluation Report Entitled:
*Controls Over the FDIC's Processing of Capital Purchase Program
Applications from FDIC-Supervised Institutions (2009-013)*

The Division of Supervision and Consumer Protection (DSC) has received and considered the recommendations from the recent evaluation of the FDIC's processing of Capital Purchase Program (CPP) applications from FDIC-supervised institutions prepared by the Office of Inspector General (OIG). We are pleased that your report states the FDIC has established controls for reviewing CPP applications which provide reasonable assurance we are complying with the U.S. Department of the Treasury's (Treasury) guidelines.

The OIG recommended that DSC reiterates to regional officials that all applications being recommended to the Treasury for approval that do not meet one or more of the Treasury viability criteria be forwarded to the CPP Council (Council) for further review. DSC concurs with this recommendation and agrees the Council should review these applications. The four applications identified in the subject evaluation that were not initially forwarded to the CPP Council, as directed under Treasury guidelines, were eventually presented to the Council. DSC will forward all such applications to the Council and remind regional and Washington Office staff of this procedure by March 27, 2009.

The OIG also recommended that decisions be reviewed by the Washington Office in instances where an applicant technically meets, or nearly meets, the Treasury viability criteria, and the region recommends the applicant withdraw its application. DSC's regional offices are provided with considerable autonomy to make supervisory determinations under delegated authority. Their close interaction with FDIC-supervised institutions places the regions in the best position to make informed judgments about safety and soundness matters. In a few isolated instances, the San Francisco Region concluded that applicants should withdraw their CPP requests because of managerial deficiencies—even though the banks met the Treasury quantitative CPP viability criteria. The Region reached this sound conclusion based on its close monitoring of the institutions' condition and management. Although we support the Region's decisions, we agree with you that it is also important to perform a Washington Office review of each recommended withdrawal that technically meets the Treasury CPP viability criteria. Going forward, a Washington Office review of such withdrawal recommendations will be implemented, and the regions advised accordingly by March 27, 2009.

MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents the management response on the recommendations in our report and the status of the recommendations as of the date of report issuance.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved: ^a Yes or No	Open or Closed ^b
1	DSC will forward all applications being recommended for approval that do not meet one or more of the Treasury viability criteria to the CPP Council for further review. DSC will remind regional and Washington Office staff of this procedure.	March 27, 2009	\$0	Yes	Open
2	Going forward, DSC will implement a Washington Office review of regional withdrawal recommendations for applications that technically meet the Treasury viability criteria and advise the regions of this review step.	March 27, 2009	\$0	Yes	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 Once the OIG determines that the agreed-upon corrective actions have been completed and are responsive, the recommendation can be closed.