

Contents

- PART I: OVERVIEW** 1
 - Message from the Ombudsman 1
 - Profile 5
 - Office of the Ombudsman Senior Leadership Team 6

- PART II: CUSTOMER ASSISTANCE GROUP** 7
 - A Day in the Life of a CAG Specialist* 8
 - Handling Complaints 9
 - Comptroller Draws Attention to CAG’s Skilled People and Effective Technology* 10
 - The Customer Assistance Group Expands Customer Access.* 12
 - CAG Improves Customer Service. 13
 - Financial Regulators Forge a Formal Agreement To Share Complaint Data.* 15
 - Update—Just Launched! HelpWithMyBank.gov Serves Bank Customers* 17
 - CAG Services Affect People’s Lives 18
 - Complaint Case Load and Trends. 20
 - CAG Outreach. 27

- PART III: APPEALS** 29
 - The National Bank Appeals Process: Ensuring Fair Treatment for National Banks.** 29
 - How the Process Works** 29
 - Value of the Process** 30
 - Appeals Summaries** 30

- PART IV: THE EXAMINATION QUESTIONNAIRE** 37
 - A Valuable Resource. 37
 - Questionnaire Contents. 37
 - Questionnaire Results 38

- PART V: APPENDIXES** 45
 - A: How To File a Customer Complaint about a National Bank or a Subsidiary of a National Bank** 45
 - B: Customer Complaint Form** 48
 - C: How To File an Appeal** 51
 - D: Frequently Asked Questions about the National Bank Appeals Process** . . . 52
 - E: Examination Questionnaire Form** 56

The National Bank Appeals Process: Ensuring Fair Treatment for National Banks

The Ombudsman, who reports directly to the Comptroller, serves as an objective arbiter to resolve bank appeals independently of the OCC's supervisory departments, through the National Bank Appeals Process. This process is designed to provide banks with an independent, fair, and binding means of settling disagreements that can arise from OCC supervisory actions or decisions.

National banks can make informal inquiries or file formal appeals in the strictest confidence without fear of retaliation.

Before the establishment of the Ombudsman's Office in 1993, national banks could appeal supervisory actions or decisions to the supervisor of the bank examiner who handled the examination or another official in the agency's bank supervisory framework. Although bank executives still have that option—and the Ombudsman's Office encourages bankers to use it—that sole avenue of appeal was not always conducive to the full airing and expeditious resolution of the issues.

The process also provides a valuable service to the OCC by identifying areas of bank supervision that can be improved.

How the Process Works

As part of the examination process, the OCC assigns ratings on the overall condition of each national bank and, sometimes, a banker disagrees with a rating. A bank executive might ask the advice of the Ombudsman or seek the office's assistance in bridging communication gaps, thereby averting a formal appeal. If a dispute cannot be resolved informally, the Ombudsman can provide an independent and objective review of the matters in dispute. In some cases, the Ombudsman may conduct his own review of the facts at issue. In cases involving banks operating under formal enforcement actions, the Ombudsman operates in a manner similar to a federal appellate court judge using a "reasonableness" test. In either case, decisions rendered by the Ombudsman are binding on the agency.

In the 13-year life of the Ombudsman's Office, the annual number of inquiries, informal appeals, and formal appeals has ranged from as few as 38, to as many as 200

In the 13-year life of the Ombudsman's Office, the annual number of inquiries, informal appeals, and formal appeals has ranged from as few as 38, to as many as 200. The matters in dispute have been just as varied, ranging from supervisory actions, to communication issues, to violations of law. Community bankers as well as large-bank managers have sought the services of the Ombudsman's Office. The issues at stake may extend beyond an individual bank and may be systemic in nature. No matter how big or small the issue, all contact with the Ombudsman is strictly confidential.

Value of the Process

The appeals process is important for several key reasons. The process contributes to the OCC's goal of maintaining open, continual communications with the institutions the agency supervises. The process also fosters fair and equitable administration of OCC supervisory processes and helps ensure the most sound supervision decisions possible. Lastly, appeals can point out, through lessons learned, areas of the supervisory process that can be improved.

Appeals Summaries

An appeal summary is prepared for each formal appeal received by the Office of the Ombudsman. Without identifying the appealing institution, each summary provides basic facts of the formal appeal, including background, discussion, and conclusions

rendered. Below is a capsule description of each summary for appeals decided in the past two years; the full text of the summaries can be found on the OCC's Web site, by going to www.occ.gov/appeals.htm.

Six of the 11 cases decided in 2006 involved appeals of composite, component, or CAMELS ratings:

- A bank appealed the downgrade of its composite rating from 2 to 3, the management rating of 3 and the execution of a memorandum of understanding. Management contended that its capital exceeded the regulatory minimum, that its principal shareholder had demonstrated the capacity to support the bank, and that the management rating should be 2 based on improving core earnings and the hiring of a new President and Senior Credit Administrator to improve credit administration and overall management of the bank. Additionally, the board stated the bank's condition had not deteriorated from the previous year, but instead had improved dramatically in all key areas supporting a composite rating of 2.

The Ombudsman found that while certain aspects of the bank's operations were improving, overall financial performance was less than satisfactory based on deterioration in credit risk management practices and insufficient earnings to support planned asset growth and capital. The Ombudsman concluded the composite rating of 3 and component ratings assigned at the examination was appropriate.

- In another case, a bank appealed the downgrades of its composite rating to a 3 and its component ratings for asset quality, management, and consumer compliance, as a result of the supervisory office findings that the bank failed to properly oversee its relationship with a third-party subprime mortgage lender. The appeal stated that the report of examination contained erroneous information regarding the bank's relationship with the third-party subprime mortgage vendor, which resulted in unsatisfactory component ratings.

The Ombudsman's review focused on whether the ratings were reasonable as assigned. After reviewing the case file and meeting with the bank's senior management and legal counsel and members of the supervisory office, the Ombudsman upheld the conclusions reached by the supervisory office.

- In a case involving a bank operating under an enforcement action, bank management appealed the composite and component ratings for capital, asset quality, management, earnings, and liquidity assigned by the supervisory office. Management stated that after the examination process was complete, the bank had improved asset quality, policies, and procedures in the lending area, and, therefore the perceived negative impact on capital, earnings, and liquidity did not materialize. The bank management contended that the component and all other ratings except liquidity should have been rated 3 and not 4, and that liquidity should have been rated 2 instead of 3. In this case, the basis of the appeal includes actions taken by management post-examination. The Ombudsman's review focused on whether the ratings were reasonable as assigned at the time of the examination, and the Ombudsman concluded that the decisions reached by the supervisory office were reasonable and well supported.
- A bank appealed the downgrade of its composite rating from 1 to 2, and the component ratings for consumer compliance, asset quality, and management. In reviewing the overall condition of the bank, the Ombudsman noted concerns about the higher risk profile, increased leverage, higher concentrations in the loan portfolio, and the need to strengthen credit risk management practices. Additionally, the bank's low risk-based capital level at the time of the examination and the low allowance for loan and lease losses provided the bank little flexibility to handle unforeseen losses of substance. The Ombudsman upgraded the compliance and management ratings, owing to the existence of a strong compliance management program including an efficient system of internal controls and the demonstrated ability

of the board and management to effectively administer the bank's affairs. However, the overall condition of the bank supported the assigned 2 composite rating.

- A bank appealed the assigned composite 3 rating and asked the Ombudsman to restore the rating to 2. The bank disagreed with the supervisory office's calculation of interest-rate risk (IRR), arguing that the more favorable measure the bank obtained from an outside service to calculate the impact of a shock to agency step-up bonds was valid. The Ombudsman acknowledged that the bank's risk exposure could legitimately be calculated differently by the supervisory office and the company the bank relied upon, but concluded that the bank's risk management processes relative to IRR did not ensure that it could withstand significant fluctuations associated with a portfolio of agency step-up bonds. Additionally, the Ombudsman's review noted a combination of weaknesses in IRR and information technology that reflected a need for enhanced supervision by the board and management. The Ombudsman determined that the conclusions reached by the supervisory office were well supported by the facts at the time of the examination.
- The boards of directors of a group of independently chartered banks collectively appealed to the Ombudsman the composite and component ratings assigned by the supervisory office. The issue involved the question of whether a group of independently chartered banks should be treated as a single complex institution or as a group of separate and independent noncomplex institutions. The Ombudsman concluded that, while the chosen corporate structure comprised individually chartered financial institutions,

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discussions showed that one principal person dominated bank management teams. Additionally, the organizational structure provided for centralized decision-making and backroom operations. Furthermore, the Ombudsman found that risk management systems throughout the banks warranted significant improvement in credit administration, nonaccrual accounting, and budget reporting. The Ombudsman concluded that the composite and component ratings as assigned by the supervisory office in the reports of examination were appropriate.

The other appeals heard by the Ombudsman's office involved a variety of issues:

- A bank formally appealed the OCC's right to retain the full semiannual assessment fee for the period of January 1 through June 30, because the bank converted to a state-chartered commercial bank on January 1. Bank management requested a full refund of its semiannual assessment because the supervisory responsibility shifted from the OCC to the state on January 1 and therefore no supervisory activities would be conducted by the OCC during the period covered by the assessment.

The Ombudsman reviewed OCC regulations on the payment of semiannual assessment fees and determined that in accordance with paragraph (5) under section (a) of 12 CFR 8, Assessment of Fees, the OCC assessment is levied against all institutions that are in the national banking system as of December 31 and June 30. Therefore, any bank that is a national bank on the assessment date must pay the full semiannual assessment for the upcoming six-month period. Finding no basis for an exception, the Ombudsman determined that no refund was due the bank.

- A bank appealed a CRA performance rating of “needs to improve,” contending that it was being penalized for its strategy of seeking lending activities outside of its assessment area.

The supervisory office stated the “needs to improve” rating was based on poor lending levels within the bank’s delineated assessment area, citing the bank had the capacity and opportunity to help meet the residential and business credit needs in its assessment area. The bank, however, directed lending activities to a market 60 miles away.

The Ombudsman considered the cumulative factors listed in the CRA performance evaluation, the performance context, and management’s supporting documentation, including acknowledgement of additional lending opportunities within the assessment area, and concluded the “needs to improve” rating was appropriate.

- A bank appealed the supervisory office decision placing a group of loans on nonaccrual status because the loans were secured by real estate. Bank management also appealed the supervisory office directive to re-file its consolidated report of condition and income (call report).

The supervisory office acknowledged the loans were secured by real estate collateral; however, at the time of examination the loans were 90 days past due and not in process of collection as defined by the call report. Additionally, the bank could not support its claims that the loans were well secured and would be repaid in full, because the appraisal was not current and was nonconforming, and the legal action initiated to collect the loans did not ensure timely and full collection.

The Ombudsman concluded the nonaccrual designation assigned by the supervisory office was appropriate, citing that the bank’s initiation of legal action did not ensure full collection of the debt and that there was inadequate support for the claim that the loans were well secured. Further, the directive to re-file the call report was appropriate, since the bank was directed to reverse all accrued and uncollected

interest and other fees and place the loan in nonaccrual status in the same quarter in which the legal process was initiated.

- A bank operating under a formal enforcement action appealed the decision by the OCC's Licensing Department to deny applications to open branches in two communities for the reason that the bank's current operating condition raised significant supervisory concerns. The Ombudsman concluded that the bank's level of progress in addressing supervisory issues and the commitment of bank management and its board to improve operations met the requirements under law for approval of the branch applications. Additionally, he found that the establishment of the branches would positively affect the local communities, while having no material impact on the safe and sound operation of the bank. Therefore, the Ombudsman concluded that the branch applications should be approved.
- The board of directors of a community bank appealed a decision to retain a memorandum of understanding it had entered into in 2002, contending that it had been rated a 2 for three consecutive years, and that the most recent examination showed stronger results in all areas except earnings. After review, the Ombudsman concluded that the MOU had served its purpose and should be terminated.