Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-11-008

Material Loss Review of Eurobank, San Juan, Puerto Rico

December 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On April 30, 2010, the Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico (OCFI) closed Eurobank, San Juan, Puerto Rico and named the FDIC as receiver. On June 2, 2010, the FDIC notified the Office of Inspector General (OIG) that Eurobank's total assets at closing were $2.1 billion and the estimated loss to the Deposit Insurance Fund (DIF) was $739.8 million. As of October 31, 2010, the estimated loss to the DIF had decreased to $737.1 million. As required by section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review of the failure of Eurobank.

The audit objectives were to (1) determine the causes of Eurobank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Eurobank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Background

Eurobank, headquartered in San Juan, Puerto Rico, was established in 1980 as an uninsured trust company named Espanola De Finanzas Trust Company, became an insured state nonmember bank in 1987, then assumed its current name in 1993. The bank was a wholly-owned subsidiary of EuroBancshares, Inc., a one-bank holding company. Although the bank marketed a range of commercial banking products and services, the bank's niche was to provide one-to-one services to small and mid-sized commercial businesses in Puerto Rico. As such, Eurobank, 1 of 10 banks operating in Puerto Rico before the bank was closed, encountered intense competition from the other institutions in Puerto Rico.

Puerto Rico's economy has been in the midst of a severe recession for a number of years. Specifically, the Puerto Rico Planning Board reported that the gross national product for the fiscal year ending June 2010 marked the island's fourth consecutive year of economic contraction. In the 2 years leading up to the Puerto Rico recession, Eurobank had a diversified loan portfolio, consisting of commercial real estate (CRE) loans, acquisition, development, and construction (ADC) loans, commercial and industrial loans, and residential real estate loans. The bank also entered the leasing business under the trade name, EuroLease. Additionally, Eurobank became reliant on wholesale funding sources, particularly brokered deposits. Over the past decade, insured depository institutions in Puerto Rico have become increasingly dependent upon non-core funding, primarily brokered deposits. U.S. tax policy and legislation enacted by the Puerto Rico government, and other sources of competition, have been identified as contributing factors to the funding structure of Puerto Rico banks.

Audit Results

Causes of Failure and Material Loss

Eurobank failed because the Board and management did not effectively oversee or appropriately react to the impact that Puerto Rico's prolonged and severe recession had on the bank's CRE and ADC loan portfolios. Management mishandled the administration of these portfolios as the economy deteriorated, real estate sales slowed, and loans became delinquent. Both portfolios represented concentrations, equaling 378 percent and 107 percent of total capital, respectively, at year-end 2007, the time at which the recession was officially recognized. Weaknesses in the bank's internal loan grading system and appraisal review process leading up to the economic downturn exacerbated losses, as did the bank's weak credit administration and underwriting of the deteriorating portfolio. Further, the bank did not adjust its risk management practices when economic conditions and the real estate market began to decline, or in response to examination recommendations aimed at strengthening internal controls. The bank's growth was funded in large part by brokered deposits, and the erosion of capital associated with loan losses stressed the bank's liquidity as the bank's ability to renew its brokered deposits became restricted and eventually prohibited. Ultimately, Eurobank was not considered viable because of the bank's deteriorating asset quality, poor earnings, and declining capital.

The FDIC's Supervision of Eurobank

Our review focused on the period from 2005 to 2010 and, during that period, the FDIC and OCFI conducted timely examinations of Eurobank. Notably, in 2006, the FDIC's New York Regional Office (NYRO) recognized the need to closely monitor economic and banking trends in Puerto Rico and those monitoring efforts led to the development of a comprehensive supervisory strategy for Puerto Rico in 2008 and 2009. As part of that broader strategy, the FDIC's supervisory attention to Eurobank was extensive and comprised of the following elements: (1) annual onsite safety and soundness examinations performed jointly with OCFI, (2) offsite monitoring activities, and (3) targeted asset quality reviews and a horizontal review of loan classifications. The FDIC's supervisory strategy was also instrumental in implementing a well-coordinated resolution of three Puerto Rico banks (Eurobank, Westernbank of Puerto Rico, and R-G Premier Bank of Puerto Rico) when they closed in April 2010.

Examiners downgraded Eurobank's management component in 2006, noting numerous oversight deficiencies, including failure to implement promised corrective action for BSA-related deficiencies, numerous apparent violations of laws and regulations, weaknesses in internal audit and management succession planning, and weaknesses in risk management practices, including funds management, asset/liability management, internal loan review, and internal controls. Downgrading the Management component for these weak practices was consistent with what is contemplated in the FDIC's forward-looking supervision program.

Weaknesses in risk management practices were repeated and more pronounced at the 2007 and 2008 examinations, and, consequently, the FDIC and OCFI progressively downgraded component and composite ratings and used enforcement actions to secure Eurobank's correction of deficiencies. Separately, the FDIC also imposed an enforcement action to address the bank's non-compliance with the Bank Secrecy Act (BSA). Although the Board had implemented corrective action to reduce the exposure in its lease portfolio in 2005, the Board failed to adequately address supervisory recommendations and enforcement measures in later years aimed at strengthening risk management practices, including funds management, CRE and ADC lending and administration practices, internal loan review, and internal controls.

A general lesson learned with respect to weaknesses in risk management practices, particularly as they relate to the lending function in general and CRE and ADC concentrations in particular, is that early supervisory intervention is prudent, even when an institution is considered *Well Capitalized* and has few classified assets. In hindsight, imposing a stronger supervisory action in 2007 may have been prudent, taking into consideration:

- the vulnerability of CRE and ADC concentrations to economic cycles;
- unique market factors that made ADC lending in Puerto Rico even riskier than in other U.S. markets;
- the importance of strong underwriting and credit administration practices in mitigating risk;
- Eurobank's growth was being fueled, in large part, by brokered deposits and the bank was becoming increasingly reliant on volatile funding;
- the Board and management's inadequate response to BSA-related deficiencies; and
- the importance of a strong internal loan review and grading system to ensure timely identification of developing problems and an accurate Allowance for Loan and Lease Losses.

Recognizing that banks in Puerto Rico faced unique challenges in attracting core deposits, greater supervisory attention and earlier criticism of the bank's overall liquidity risk profile might also have been prudent. The FDIC has taken a number of actions to address banks that have risk profiles similar to Eurobank, including instituting a training initiative on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner.

Management Response

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On December 2, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. DSC reiterated the OIG's conclusions regarding the causes of Eurobank's failure. With regard to our assessment of the FDIC's supervision of Eurobank, DSC described its supervisory approach and actions taken in response to weaknesses in the bank's risk management practices, including rating downgrades and use of enforcement actions between 2006 and 2010, as discussed in our report. DSC's response noted that Eurobank's Board and management failed to adequately address supervisory recommendations and enforcement measures. Further, DSC's response stated that supervisory guidance has been issued to enhance supervision of institutions, such as Eurobank, that rely heavily on volatile funding sources. In addition, DSC stated it has completed an examiner training program, as discussed in our report, which emphasizes a forward-looking approach when assessing a bank's risk profile. The early use of informal enforcement actions to pursue corrective of weak risk management practices is consistent with forward-looking supervision.

Contents

DATE: December 2, 2010

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

/Signed/

FROM: Stephen M. Beard
Assistant Inspector General for Material Loss Reviews

SUBJECT: *Material Loss Review of Eurobank, San Juan, Puerto Rico* (Report No. MLR-11-008)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of Eurobank, San Juan, Puerto Rico. The Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico (OCFI) closed the institution on April 30, 2010, and named the FDIC as receiver. On June 2, 2010, the FDIC notified the OIG that Eurobank's total assets at closing were $2.1 billion and the estimated loss to the Deposit Insurance Fund (DIF) was $739.8 million. As of October 31, 2010, the estimated loss to the DIF had decreased to $737.1 million. The estimated loss exceeds the $200 million MLR threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Financial Reform Act.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

The objectives of this material loss review were to (1) determine the causes of Eurobank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Eurobank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Eurobank's failure and the FDIC's efforts to ensure that the Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss reviews, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[1] Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of key terms, including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System, otherwise known as the CAMELS ratings. Appendix 3 contains a list of acronyms. Appendix 4 presents examiner comments on reports of examination from 2005 to 2009. Appendix 5 contains the Corporation's comments on the report.

Background

History and Description of Eurobank

Eurobank, headquartered in San Juan, Puerto Rico,[2] was established in 1980 as an uninsured trust company named Espanola De Finanzas Trust Company, became an insured state nonmember bank in 1987, then assumed its current name in 1993. The bank was a wholly-owned subsidiary of EuroBancshares, Inc., a one-bank holding company. Eurobank, like other banks in Puerto Rico, was also highly dependent on brokered deposits as a result of changes in tax laws, as discussed in more detail below. Table 1 provides details on Eurobank's financial condition as of March 31, 2010, and for the 5 preceding calendar years.

Table 1: Financial Information for Eurobank, 2005 to 2010

Financial Measure ($000s)	Mar-10	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets	2,453,138	2,561,343	2,859,489	2,750,773	2,500,164	2,392,021
Total Loans	1,516,985	1,546,063	1,769,578	1,857,219	1,749,959	1,576,260
Total Investments	851,170	929,751	984,266	790,373	677,117	745,169
Total Deposits	1,861,350	1,970,724	2,084,853	1,993,905	1,905,831	1,734,650
Brokered Deposits	1,074,618	1,141,634	1,423,814	1,336,560	1,226,156	967,206
Federal Funds	468,675	468,674	556,475	496,419	365,664	419,860
Net Income (Loss)	(3,709)	(70,975)	(9,963)	4,757	10,249	18,068

Source: Uniform Bank Performance Reports (UBPR) for Eurobank.

Eurobank was a full-service commercial bank and operated 27 offices in 17 Puerto Rico counties. Eighty-four percent of Eurobank's total deposits were held in San Juan County, but Eurobank's growth strategy involved increasing its presence outside of the San Juan metropolitan area by following Puerto Rico's primary traffic arteries to new locations poised for growth. The bank's strategy resulted in branch locations that were near approximately 80 percent of the island's population.

Although the bank marketed a range of commercial banking products and services, the bank's niche was to provide one-to-one services to small and mid-sized commercial businesses in Puerto Rico. As such, Eurobank, 1 of 10 banks operating in Puerto Rico

[1] A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of our report.
[2] Puerto Rico is a territory of the United States (U.S.) and the fourth largest Caribbean island.

before the bank was closed,[3] encountered intense competition from the other commercial lending institutions in Puerto Rico that are similar to credit unions, known as "cooperativas." In the 2 years leading up to the Puerto Rico recession, the bank maintained about 30 to 32 percent in CRE loans and 10 to 13 percent in ADC loans. Commercial and Industrial (C&I) loans and residential real estate made up 16 percent and 11 percent of the bank's portfolio, respectively. The bank had also entered into a leasing business under the trade name, EuroLease, which comprised 21 percent of the bank's loan portfolio at year-end 2007.

Economic Conditions in Puerto Rico

Puerto Rico's economy has been in the midst of a severe recession for a number of years. In fact, while the U.S. recession is considered to have ended in June 2009,[4] Puerto Rico's economy remains in a recession. Specifically, the Puerto Rico Planning Board reported that the gross national product for the fiscal year ending June 2010 marked the island's fourth consecutive year of economic contraction. Reported factors contributing to the economic contraction include the significant increase in oil prices, the budgetary pressures on government finances, and continuous loss of manufacturing jobs. The decline in employment on the island has been acute, and the percentage of jobs lost has been nearly double the U.S. rate. Between December 2004 and September 2010, Puerto Rico lost 133,000 jobs, a 12.6-percent decline. Unemployment in Puerto Rico has also climbed. The unemployment rate reached 17.2 percent in April 2010, the island's highest rate in 17 years. The unemployment rate eased to 16.0 percent in September 2010 but remains well above the U.S. rate of 9.6 percent.[5] Further, the sharp downturn in the U.S. economy has exacerbated the island's plight as exports of goods to the U.S. have plummeted and tourism has declined.[6]

Although Puerto Rico's economy is closely linked to the U.S. economy, job losses in Puerto Rico pre-date job losses in the U.S. by 3 years and have their root in changes in the island's tax structure. More specifically, the Tax Reform Act of 1976 established the possessions tax credit under Section 936, which was enacted to encourage economic development in U.S. possessions such as Puerto Rico, U.S. Virgin Islands, and Guam. Section 936 exempted U.S. corporations from paying federal income tax on profits generated by a qualified Puerto Rican subsidiary of a U.S. corporation. The stated purpose of this tax credit was to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations." Indeed, while the tax law was in effect, Puerto Rico's manufacturing base experienced strong employment growth.

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[3] Three of the 10 banks in Puerto Rico, Eurobank, Westernbank Puerto Rico (Westernbank) and R-G Premier Bank of Puerto Rico (R-G Premier), were closed on April 30, 2010.
[4] In September 2010, the Business Cycle Dating Committee of the National Bureau of Economic Research, an independent group of economists, met and determined that a trough in business activity occurred in the U.S. economy in June 2009. The trough marks the end of the declining phase and the start of a rising phase of the business cycle.
[5] U.S. unemployment data as of October 2010 from the U.S. Department of Labor, Bureau of Labor Statistics.
[6] For purposes of this discussion, we used U.S. to refer to the 50 states.

During the 1980s and early 1990s, several large U.S.-based pharmaceutical, medical equipment, and metals manufacturing companies opened or expanded their operations in Puerto Rico, which resulted in manufacturing surpassing agriculture as the primary source of domestic income. However, legislation enacted in 1996 phased out the tax incentives over a 10-year period and has been identified as a key factor in manufacturing-related job losses on the island. Other reasons cited for the decline in Puerto Rico's manufacturing job base include an escalation in local labor and energy costs relative to international competitors and the loss of patents on some pharmaceutical products that are produced in Puerto Rico.

The sharp decline in economic activity has had a negative impact on the Puerto Rico housing market. Similar to the U.S., home prices and new home construction on the island have declined steadily since 2006 and contributed to a sharp decline in the number of construction jobs. For example, between June 2004 and June 2009, the island lost one-third of its construction-sector workforce. In contrast, construction-related job losses started 2 years later across the U.S., down approximately 19 percent since 2006. The reduction in new construction activity in Puerto Rico occurred about the same time as it did in the U.S., but the percentage declines have been more severe.

Funding Structure of Puerto Rico Banks

Over the past decade, insured depository institutions in Puerto Rico have become increasingly dependent upon non-core funding, primarily brokered deposits. Between June 30, 1999 and June 30, 2009, brokered deposits increased from 13 percent to 40 percent of total deposits. U.S. tax policy and legislation enacted by the Puerto Rico government, and other sources of competition from "cooperativas" (state-chartered institutions similar to credit unions) have been identified as contributing factors to the funding structure of Puerto Rico banks.

In addition to promoting job growth, while Section 936 was in effect, corporations were subject to a passive income tax on repatriated profits.[7] The tax was passed by the Puerto Rican government and led companies to maintain deposits at local banks, rather than repatriating all profits. This practice resulted in a strong, low-cost funding source for local banks. The repeal of Section 936 had a dramatic impact on local banks' ability to retain their deposits. To illustrate, according to information provided by FDIC officials, it was estimated that banks lost more than 90 percent, or approximately $7.4 billion in deposits, from the manufacturing section in 2003 with the repeal of Section 936.

Additionally, over the last 10 years, Puerto Rico Investment Companies (PRICs) have attracted deposits away from banks. More specifically, the Investment Companies Act of Puerto Rico led to the organization and growth of PRICs, which are similar to mutual funds. Most of these PRICs offer tax-advantageous products that compete directly with bank deposits. "Cooperativas" are another source of competition for retail funding in Puerto Rico. As of March 31, 2009, there were 123 "cooperativas" on the island. As a result of the limited deposit market and the number of institutions on the island,

[7] Those profits that foreign corporations returned to their country from operations in Puerto Rico.

competition for local deposits is strong. In addition, local retail deposits generally tend to be priced higher than brokered deposits, and banks find that brokered deposits are a lower cost funding mechanism for growth.

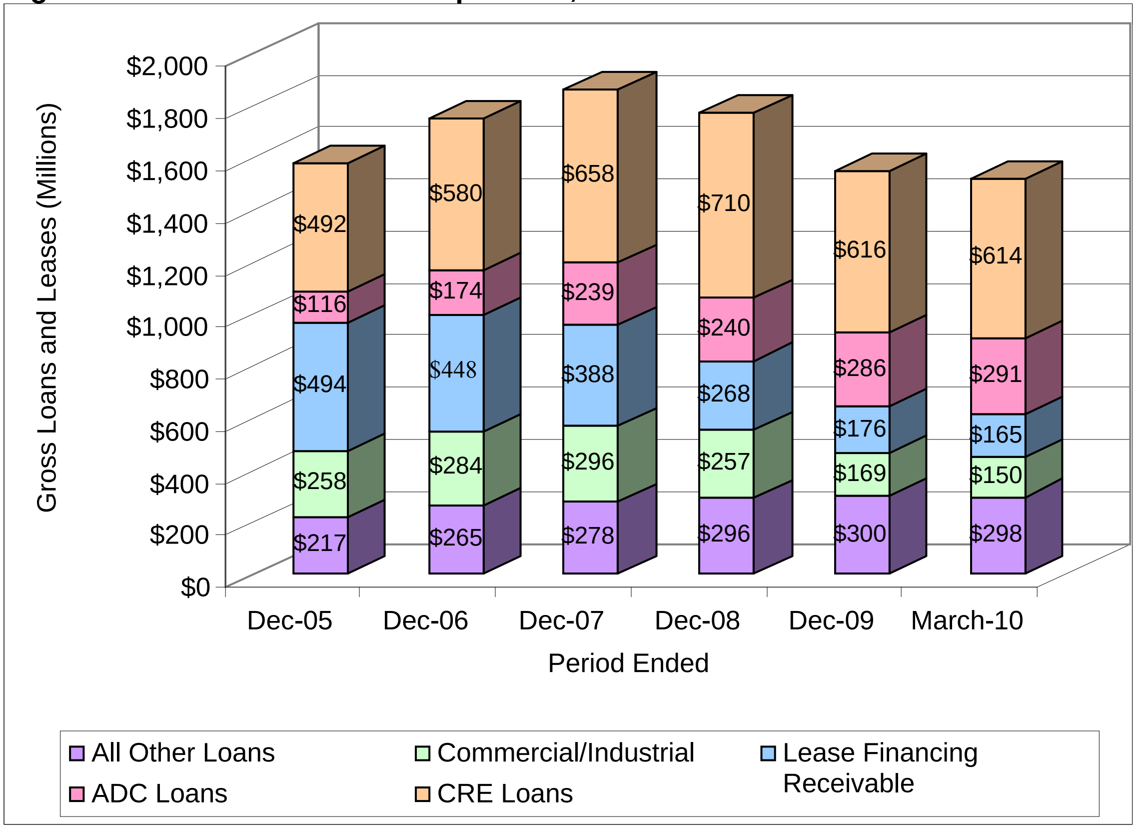
Causes of Failure and Material Loss

Eurobank failed because the Board and management did not effectively oversee or appropriately react to the impact that Puerto Rico's prolonged and severe recession had on the bank's CRE and ADC loan portfolios. Management mishandled the administration of these portfolios as the economy deteriorated, real estate sales slowed, and loans became delinquent. Both portfolios represented concentrations, equaling 378 percent and 107 percent of total capital, respectively, at year-end 2007, the time at which the recession was officially recognized. Weaknesses in the bank's internal loan grading system and appraisal review process prior to the economic downturn exacerbated losses, as did the bank's weak credit administration and underwriting of the deteriorating portfolio. Further, the bank did not adjust its risk management practices when economic conditions and the real estate market began to decline, or in response to examination recommendations aimed at strengthening internal controls. The bank's growth was funded in large part by brokered deposits, and the erosion of capital associated with loan losses stressed the bank's liquidity as the bank's ability to renew its brokered deposits became restricted and eventually prohibited. Ultimately, Eurobank was not considered viable because of the bank's deteriorating asset quality, poor earnings, and declining capital.

Board and Management's Lending Strategy

Historically, the bank pursued a traditional business plan, including ADC and CRE lending in Puerto Rico. With the ultimate goal of increasing its net income, the Board and management grew assets from $1.3 billion as of December 31, 2003 to $2.9 billion by December 31, 2008. They did so, in part, by increasing CRE and ADC lending, including speculative construction loans for new properties and lines of credit to renovate commercial real estate properties. As discussed later in this report, Eurobank's growth was funded largely by brokered deposits. Figure 1 illustrates the growth and composition of Eurobank's loan portfolio.

Figure 1: Eurobank's Loan Composition, 2005 to 2010



Source: Reports of Condition and Income (Call Reports) for Eurobank.

As illustrated, in addition to its CRE and ADC portfolio, Eurobank had a considerable lease portfolio. The bank primarily originated automobile leases, but the portfolio also included leases for medical and construction equipment. Eurobank viewed leases to be a riskier product type than commercial lending. However, Eurobank characterized its automobile leases as finance leases, meaning the lessee was responsible for the residual value of the automobile at the end of the lease term, which Eurobank considered to mitigate risks associated those values being volatile. Eurobank's automobile lease portfolio generated a significant amount of loan and lease losses, but the majority of the charge-offs occurred prior to 2008. CRE and ADC charge-offs that occurred in 2008 and 2009 were more significant to the bank's failure.

Eurobank's commercial loan portfolio included lines of credit to finance operations; provide working capital for specific purposes; and purchase assets, equipment, or inventory. For these types of loans, the primary source of repayment is generally a borrower's cash flow from operations. As such, these loans can be sensitive to economic downturns. ADC lending is also inherently vulnerable to economic conditions and real estate markets. Eurobank sought to market its construction loans to experienced real estate developers who developed residential units throughout the island, with particular emphasis on single-family homes and townhomes. Eurobank's construction loans generally had terms of 18 months, with options to extend for additional periods to complete construction and the sale of the units.

FDIC officials also explained that there were market factors in Puerto Rico that increased the risk of ADC lending. In Puerto Rico, developers are not allowed to enter into long-term pre-sales contracts with non-refundable deposits. Thus, the bank's only assurance of commitment to a project is deposits, which are fully refundable. For example, these deposits (referred to as options in Puerto Rico) are generally less than $10,000, with some as low as $2,500, and are refundable upon request for a $50 administrative fee. Because purchase options are entirely in the favor of the buyer, examiners considered residential development projects to be riskier. In addition, we understand that the process for obtaining construction permits in Puerto Rico can take between 3 to 5 years, which is longer than in other U.S. markets and, thereby increases the bank's market risk.

In December 2006, federal banking regulatory agencies issued guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance) that reinforces existing regulations and guidelines for real estate lending and safety and soundness.[8] The Joint Guidance focuses on those CRE loans for which cash flow from real estate is the primary source of repayment (i.e., ADC lending). The guidance was issued because the agencies had observed that CRE concentrations had been rising and could create safety and soundness concerns in the event of a significant downturn.

The Joint Guidance states that rising CRE concentrations can expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. Earlier supervisory guidance emphasized that ADC lending is a highly specialized field with inherent risks that must be managed and controlled to ensure that this activity remains profitable.[9] Supervisory guidance also states that an institution's Board is responsible for establishing appropriate risk limits, monitoring exposure, and evaluating the effectiveness of the institution's efforts to manage and control risk. As discussed below, Eurobank failed to effectively manage and control risk associated with its CRE and ADC portfolios, particularly as economic conditions on the island deteriorated.

Due to the risks associated with CRE and ADC lending, regulators consider institutions with significant CRE and ADC concentrations to be of greater supervisory concern. The Joint Guidance defines institutions that may be identified for further supervisory analysis of the level and nature of their concentration risk as those reporting loans for construction, land and development, and other land (i.e., ADC) representing 100 percent or more of total capital; or institutions reporting total CRE loans representing 300 percent or more of total capital, where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months. As shown in Figure 2, Eurobank's growth in CRE lending in the years leading up to the issuance of the Joint Guidance caused it to meet the threshold of possibly warranting increased supervisory attention. Eurobank's

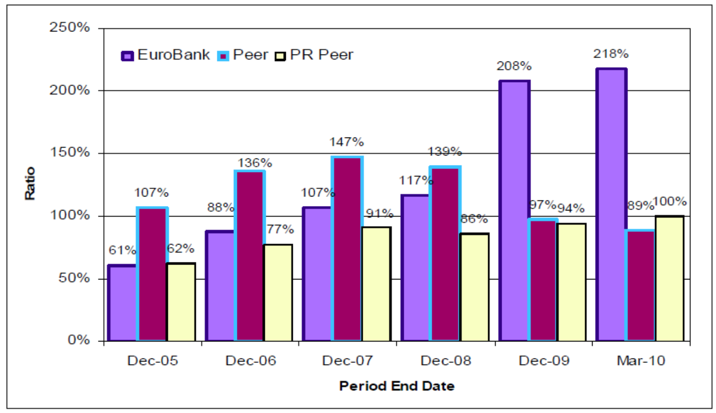
[8] The guidance was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as the agencies in the guidance).
[9] Financial Institution Letter (FIL)-110-98, entitled, *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending,* dated October 8, 1998.

concentrations of both CRE and ADC increased as a percentage of capital in 2009 and 2010 as losses from those portfolios eroded its capital base.

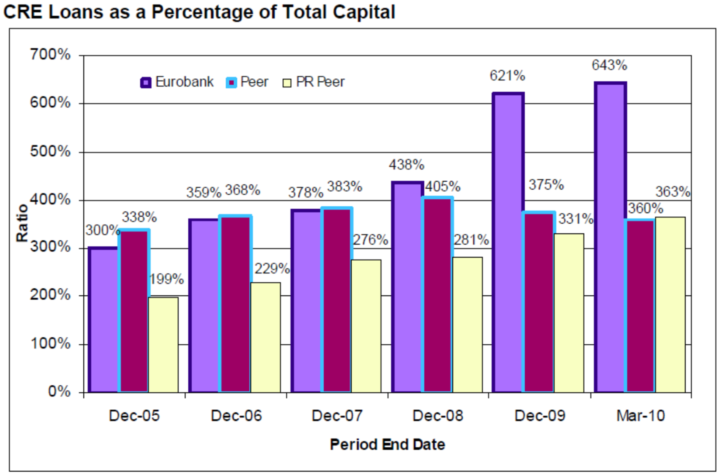
In the midst of a severe economic decline in Puerto Rico and absent effective risk management practices, Eurobank's asset quality rapidly deteriorated. The volume of Adversely Classified Items (ACI) increased over 300 percent from 2007 to 2008. Specifically, as of August 30, 2008, ACI totaled $408 million or 181 percent of Tier 1 Capital plus the Allowance for Loan and Lease Losses (ALLL) compared to $98 million or 47 percent as of September 30, 2007. A substantial part of the increase came from the ADC loan portfolio. Although ADC loans totaled approximately 14 percent of all loans, those loans accounted for over 50 percent of total ACI. Figure 3 shows the breakdown of loan charge-offs by loan type. As discussed earlier, the majority of the CRE and all of the ADC charge-offs occurred in 2008 and 2009.

Figure 2: Eurobank's ADC and CRE Loans as a Percentage of Total Capital Compared to Peer, 2005 to 2010

ADC Loans as a Percentage of Total Capital



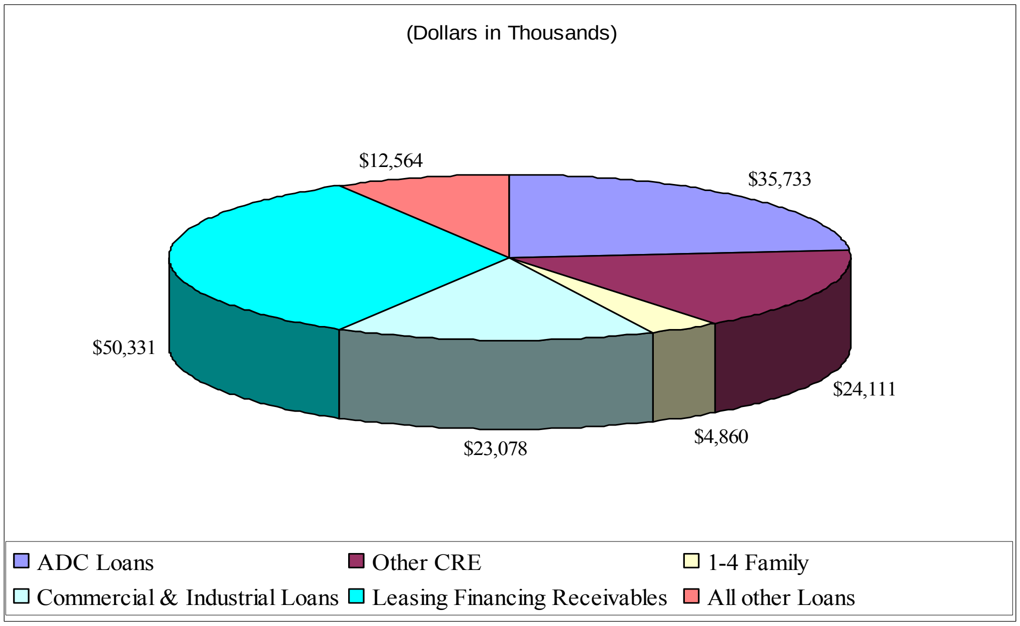
CRE Loans as a Percentage of Total Capital



Source: UBPRs for Eurobank.

Note: The significant increase in the concentrations ratios in 2009 and 2010 was due primarily to the decline in the bank's total capital.

Figure 3: Eurobank's Net Charge-off on Loans and Leases, 2005 to 2009



Source: Call Reports for Eurobank.

Ultimately, the rapid decline in the CRE and ADC portfolios in 2008 and 2009 diminished Eurobank's earnings, with operating losses beginning in 2008. As a result of loan loss provision expenses, capital ultimately became inadequate to support the bank's high-risk profile.

Loan Underwriting and Credit Administration Practices

The Joint Guidance reiterates that concentrations in CRE lending, coupled with weak loan underwriting and depressed CRE markets, contributed to significant credit losses in the past. According to the Joint Guidance:

- strong risk management practices are an important element of a sound CRE lending program, particularly when an institution has a concentration in CRE loans;

- financial institutions with CRE concentrations should ensure that risk management practices appropriate to the size of the portfolio, as well as the level and nature of concentrations, and the associated risk to the institution are implemented; and

- financial institutions should establish a risk management framework that effectively identifies, monitors, and controls CRE concentration risk.

In addition, FIL-22-2008, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, issued March 17, 2008, provides key risk management processes for institutions with CRE concentrations, including maintaining prudent, time-tested lending policies with a strong credit review and risk rating system to identify deteriorating credit trends early and maintaining updated financial and analytical information for borrowers. For example, institutions should emphasize global financial analysis of obligors, which involves analyzing borrowers' complete financial resources and obligations. The guidance further states that inappropriately adding extra interest reserves on loans where the underlying real estate project is not performing as expected can erode collateral protection and mask loans that would otherwise be reported as delinquent.

Puerto Rico's prolonged and severe economic recession led to rapid deterioration in the ADC and CRE loan portfolios. However, management's lack of response to deteriorating economic conditions significantly contributed to the decline in asset quality experienced by Eurobank. Despite repeated recommendations to enhance its internal loan review and grading process, management did not timely identify loans adversely affected by the local economic downturn and, as a result, failed to maintain an appropriate ALLL. Further, management failed to properly manage the CRE and ADC portfolio as conditions deteriorated. Management allowed new funding for interest reserves on raw land loans; replenished interest reserves on extended ADC loans that were clearly troubled debt; in certain cases, relied on nonconforming appraisals at loan origination or renewal/extension, resulting in violations of law and contraventions of regulatory guidance; and failed to monitor exceptions to regulatory loan-to-value (LTV) guidelines, resulting in contravention of regulatory guidance and unknown exposure to value declines.

Loan Underwriting and Credit Administration

Examples of deficient underwriting and credit administration practices identified by examiners included the following:

Multiple Interest Reserves. Examiners in 2008 identified many instances in which the Board approved multiple interest reserves on ADC loans that were clearly troubled, lacked support from the guarantors, and were collateral dependent. In many cases, the extensions were made without an updated appraisal despite a material change in market conditions. In some instances, unsecured loans were made to the guarantor and/or affiliated company, and the proceeds were used to keep existing loans current. Also, loan extensions were made with new funding for interest reserves that resulted in LTV ratios in excess of 100 percent. These practices were in violation of FDIC Rules and Regulations Part 323, *Appraisals* and in nonconformance with Appendix A of Part 365, *Interagency Guidelines for Real Estate Lending Policies,* as well as Eurobank's loan policy.

Weak Internal Controls. Eurobank failed to establish appropriate internal controls related to its credit function. Specifically, Eurobank lacked an independent credit function that analyzed proposed loans prior to submission to the Board for approval. In addition, there was no separation of duties between the lending and loan administration functions. For example, loan officers and their superiors prepared Board packages, determined that Board-approval conditions were met prior to disbursement, and approved disbursements with no evidence of review for compliance with Board-approved conditions and/or covenants. Further, loan officers approved disbursements with no evidence that a project was within the approved budget.

Lack of Reporting to the Board. Beginning in 2008, management did not keep the Board informed of the deteriorating conditions in the loan portfolio. Examination reports indicated that there was an apparent lack of communication between the Board, senior management, and middle management. For example, the bank's loan policy called for a monthly status report on troubled ADC loans by the bank's senior ADC loan officer. However, management confirmed that these reports were not made to the Board, despite obvious deterioration in the ADC portfolio. Eurobank's loan policy also called for the monthly submission of flow charts, which were intended to track progress on development projects, and also required that credit files include periodic narrative summaries for each ADC loan retained. Management also failed to comply with these requirements.

Failure to Obtain Updated Appraisals. The 2008 examination reported that Eurobank was in apparent violation of section 323.3(a)(7) of the FDIC Rules and Regulations, which states, in part, that an appraisal is required for all real estate-related financial transactions in excess of $250,000 except those in which the transaction involves an existing extension of credit at the lending institution, provided that there have been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies. Eurobank extended new financing for 11 loans without obtaining a new appraisal, although material declines in the residential real estate market in Puerto Rico were evident.

Deficient Appraisal Review. The bank's appraisal review process was flawed and the loan review function lacked expertise in appraisal review. This deficiency contributed to the understatement of the estimated loss incurred for loans that were impaired and collateral dependent. In addition, the bank was in apparent contravention of the *Interagency Appraisal and Evaluation Guidelines*, as several appraisals for ADC loans did not include the current market value of the property in its actual physical condition. Appraisals were accepted that did not meet regulatory standards by the bank's appraisal reviewer, which in turn led to underwriting decisions based on inaccurate information. In 2008, examiners recommended that the bank undertake a comprehensive review of its appraisal review function to ensure that appraisals were based on regulatory standards and subsequent loss estimations were accurate.

Insufficient Loan Policy. The 2007 examination reported that Eurobank's loan policy needed to be revised in order to adequately address the requirements of Appendix A to the FDIC's Rules and Regulations Part 365, *Interagency Guidelines for Real Estate Lending Policies*. The policy was insufficient to ensure that proper tracking and monitoring procedures were in place to monitor LTV limitations and compliance with capital thresholds. Further, the policy needed to be improved to specify the level and types of loans deemed appropriate, and establish a reporting arrangement so that the

Board could review compliance with guidelines and respond timely to changing economic conditions.

Weak Internal Loan Review. During the 2007 and 2008 examinations, examiners identified significantly more adversely classified loans than recognized by the bank's internal loan review. During the 2007 examination, eight commercial loans aggregating $43.2 million had not been properly classified by management, of which $32.1 million or 74 percent were adversely classified construction loans. Examiners also identified construction loans that warranted a substandard classification that were not adversely classified, or included on the bank's Watch List as special mention. In 2008, Eurobank had difficulty providing a list of its largest credit relationships, which likely impeded its internal loan review process. The timely identification and accurate classification of problem loans is critical to an adequate ALLL level.

Allowance for Loan and Lease Losses

On December 13, 2006, the federal banking regulatory agencies issued an *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (ALLL Policy Statement) that reiterated key concepts and requirements related to generally accepted accounting principles[10] and existing supervisory guidance. Specifically, the ALLL Policy Statement describes the nature and purpose of the ALLL; the responsibilities of boards of directors, management, and examiners; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound credit grading system. An institution's process for determining the ALLL should be based on a comprehensive, well-documented, and consistently applied analysis of its loan portfolio that considers all significant factors that affect collectability. That analysis should include an assessment of changes in economic conditions and collateral values and their direct impact on credit quality. If declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, the ALLL level as a percentage of the portfolio should generally increase, barring unusual charge-off activity.

Eurobank's methodology for determining its ALLL was hampered due to the weak internal loan review process described in the prior section of this report. Examiners reported weaknesses and/or made recommendations regarding Eurobank's ALLL at each examination from 2005 to 2009. For example,

- 2005 -- Examiners recommended that management take into account recent trends and growth patterns in different unclassified loan categories in calculating the adequacy of the ALLL. They also recommended improving the back-up documentation used to calculate the adequacy of the ALLL.

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[10] In 2009, the accounting standards were codified. Former Statement of Financial Accounting Standards (FAS) No. 5, *Accounting for Contingencies,* is now covered in Accounting Standard Codification (ASC) Subtopic 450-20. Former FAS No. 114, *Accounting by Creditors for Impairment of a Loan*, is now covered in ASC 310-10-35. These standards provide accounting guidance for loss contingencies on a pool basis and impairment of loans on an individual basis, respectively.

- 2006 -- Eurobank's June 30, 2006 internal loan review did not identify any losses in the commercial loan category. However, the examiners identified losses of $1.4 million during the examination. Furthermore, examiners moved a number of classified loans to a lower classification category. As a result, the ALLL was under funded by $760,000.

- 2007 -- Examiners found the ALLL level to be appropriate. However, they reported that the internal loan review process needed improvement. Examiners recommended that management formalize the lines of communications between loan officers, managers, and the internal loan review department in order to identify problem credits in a timely manner. The timely identification and accurate classification of problem loans is critical to an adequate ALLL level.

- 2008 -- Due to the increasing trend in adversely classified, past due, and non accrual loans, and the understated estimations of loss in the ADC portfolio, the ALLL balance was deemed insufficient to absorb the risk of loss in the loan portfolio. Examiners noted that the continuing problems in the construction sector of the Puerto Rico economy would continue to negatively affect the bank's ADC portfolio, as slower housing sales and higher holding costs would result in higher loss estimates. Thus, Eurobank would have to review FASB 114 estimations of loss each quarter to determine their adequacy.

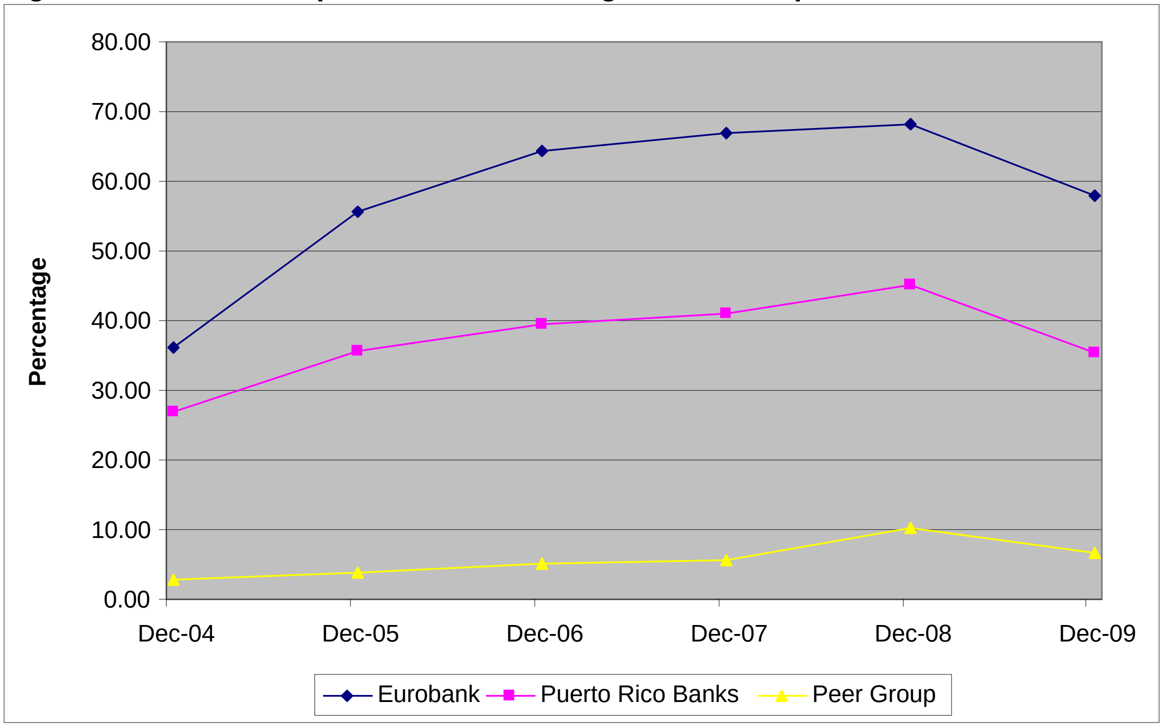
- 2009 -- Examiners reported that the main reason for the inadequate ALLL was management's inability to identify problem loans due to an inadequate loan monitoring system. Also, the bank's ALLL policy guidance did not provide procedures for determining when a loan was impaired or for calculating impairment.

Reliance on Wholesale Funding Sources

As discussed earlier in the report, banks in Puerto Rico are highly dependent on brokered deposits due to the challenges banks on the island faced attracting core deposits. Notably, the repeal of Section 936, as well as competition from "cooperativas" and PRICs contributed to the banks' increased dependence on brokered deposits. As such, Eurobank became reliant on wholesale funding sources, particularly brokered deposits and Federal Funds,[11] to support its asset growth. Figure 4 shows brokered deposits as a percentage of total deposits for Eurobank, Puerto Rico banks, and Eurobank's peer group.

[11]Federal funds, or Fed Funds, are unsecured loans of reserve balances at Federal Reserve Banks that depository institutions make to one another.

Figure 4: Brokered Deposits as a Percentage of Total Deposits, 2004 to 2010



Source: UBPRs for Eurobank.

Eurobank more than doubled its brokered deposits from $511 million in December 2004 to a high of $1.4 billion in December 2008. Placing heavy reliance on volatile funding sources to support asset growth is risky because access to these funds may become limited during distressed financial or economic conditions. Table 2 illustrates Eurobank's net non-core funding dependency ratios between December 2004 and the bank's failure. During this period, Eurobank's net non-core funding dependency ratio consistently and significantly exceeded its Puerto Rican peer group averages for such funding sources. The net non-core funding dependency ratio is a measure of the degree to which an institution relies on non-core funding to support longer-term assets (e.g., loans that mature in more than 1 year). An elevated ratio reflects heavy reliance on potentially volatile funding sources that may not be available in times of financial stress.

Table 2: Eurobank's Net Non-Core Funding Dependency Ratio Compared to Peer, 2005 to 2010

	Mar-10	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05
Eurobank	81.65	80.86	82.51	79.95	74.31	66.81
State Peer Group*	63.17	59.25	68.56	65.52	69.34	69.81

Source: UBPRs for Eurobank.
* Puerto Rico

The FDIC's Rules and Regulations Part 337, *Unsafe and Unsound Banking Practices*, states that any *Well Capitalized* insured depository institution may solicit and accept, renew, or roll over any brokered deposits without restriction. Under the FDIC's Rules and Regulations, restrictions on brokered deposits are imposed when an institution falls below *Well Capitalized*. Under Part 337, *Adequately Capitalized* institutions may request a waiver from this prohibition; however, *Undercapitalized* institutions are prohibited from obtaining or rolling over brokered deposits. As its condition deteriorated due to Puerto Rico's economic distress, Eurobank indeed became concerned that it could be required to sell assets at a loss in order to fund broker deposit withdrawals and other liquidity needs if the FDIC did not grant a waiver for the renewal of maturing brokered deposits. As discussed later in this report, Eurobank's capital level fell from *Well Capitalized* to *Adequately Capitalized,* and the bank did become dependent on FDIC's approval of a broker deposit waiver in order to meet liquidity needs and remain viable.

The FDIC's Supervision of Eurobank

Our review focused on the period from 2005 to 2010, and, during that period, the FDIC and OCFI conducted timely examinations of Eurobank. Notably, in 2006, the FDIC's New York Regional Office (NYRO) recognized the need to closely monitor economic and banking trends in Puerto Rico, and those monitoring efforts led to the development of a comprehensive supervisory strategy for Puerto Rico in 2008 and 2009. As part of that broader strategy, the FDIC's supervisory attention to Eurobank was extensive and comprised of the following elements: (1) annual onsite safety and soundness examinations performed jointly with OCFI, (2) offsite monitoring activities, and (3) targeted asset quality reviews (TAQR) and a horizontal review of loan classifications.[12] The FDIC's supervisory strategy was also instrumental in implementing a well-coordinated resolution of Eurobank, Westernbank, and R-G Premier when they closed in April 2010.

Examiners downgraded the Management component in 2006, noting numerous oversight deficiencies, including failure to implement promised corrective action for Bank Secrecy Act (BSA)-related deficiencies; numerous apparent violations of law and regulation; weaknesses in internal audit and management succession planning; and weaknesses in risk management practices, including funds management, asset/liability management, internal loan review and internal controls. Downgrading the Management component for these weak practices was consistent with what is contemplated in the FDIC's forward-looking supervision program.

Weaknesses in risk management practices were repeated and more pronounced at the 2007 and 2008 examinations, and, consequently, the FDIC and OCFI progressively downgraded component and composite ratings and used enforcement actions to secure Eurobank's correction of deficiencies. Separately, the FDIC also imposed an enforcement action to address the bank's non-compliance with the BSA. Although the Board had implemented corrective action to reduce the exposure in its lease portfolio in 2005, it failed to adequately address supervisory recommendations and enforcement measures in later years aimed at strengthening risk management practices, including

[12] Nine of the institutions in Puerto Rico were designated as Minority Depository Institutions (MDIs). Recognizing the concentration of MDIs in Puerto Rico and the large asset size of these institutions, the NYRO also held annual MDI conferences in Puerto Rico exclusively for these banks.

funds management, CRE and ADC lending and administration practices, internal loan review, and internal controls.

A general lesson learned with respect to weaknesses in risk management practices, particularly as they relate to the lending function in general and CRE and ADC concentrations in particular, is that early supervisory intervention is prudent, even when an institution is considered *Well Capitalized* and has few classified assets. The FDIC began downgrading ratings at the 2006 examination and used enforcement actions to secure corrective action in subsequent examinations. In hindsight, imposing a stronger supervisory action in 2007 may have been prudent, taking into consideration:

- the vulnerability of CRE and ADC concentrations to economic cycles;
- that unique market factors made ADC lending in Puerto Rico even riskier than in other U.S. markets;
- the importance of strong underwriting and credit administration practices in mitigating risk;
- that Eurobank's growth was being fueled, in large part, by brokered deposits and the bank was becoming increasingly reliant on volatile funding;
- the Board and management's inadequate response to BSA-related deficiencies; and
- the importance of a strong internal loan review and grading system to ensure timely identification of developing problems and an accurate ALLL.

For example, the FDIC could have imposed a stronger supervisory action in 2007 to address credit administration deficiencies identified at that examination and to require additional capital, in light of weaknesses in asset quality and risk management practices. Recognizing that banks in Puerto Rico faced unique challenges in attracting core deposits, greater supervisory attention and earlier criticism of the bank's overall liquidity risk profile might also have been prudent. The FDIC has taken a number of actions to address banks that have risk profiles similar to Eurobank, including instituting a training initiative on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management.

Supervisory History

Examination History

From 2005 to 2010, the FDIC and OCFI completed four joint examinations and two TAQRs of Eurobank. In addition, the FDIC monitored the bank's financial condition using various offsite monitoring tools. Table 3 provides the examination history of Eurobank from 2005 to 2010.

Table 3: Examination History of Eurobank, 2005 to 2010

Examination Start Date	Examination As of Date	Agency	Supervisory Ratings (UFIRS)	Supervisory Action
06/06/2005	03/31/2005	Joint	222221/2	None Applicable.
08/31/2006	06/03/2006	Joint	223222/2	Cease & Desist Order (C&D) effective March 15, 2007.*
10/29/2007	09/30/2007	Joint	333333/3	Bank Board Resolution (BBR) adopted August 22, 2008.**
08/31/2008	06/30/2008	FDIC (TAQR)	N/A	A composite "4" interim downgrade was processed in February 2009.
12/29/2008	09/30/2008	Joint	444443/4	C&D issued on October 9, 2009.
09/28/2009	06/30/2009	Joint (TAQR)	554543/5	An interim downgrade was processed in December 2009.

Source: ROEs, enforcement actions, and problem bank memorandums for Eurobank.
*This C&D was a result of Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) weaknesses noted in the August 2006 examination (referred to in this report as the BSA Order). This order remained in effect through the bank's closure.
**BBR was adopted to address safety and soundness issues.

Offsite Monitoring

In addition to onsite examinations, the FDIC provided continuous offsite monitoring, including periodic contact with bank management and analysis of Call Report data. The offsite review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. The FDIC generates an offsite review list (ORL) each quarter and performs offsite reviews for each bank that appears on the list. The findings of these reviews are factored into examination schedules and other supervisory activities. The system-generated offsite review list includes only institutions rated "1" and "2" that are either:

- identified by Statistical CAMELS Offsite Rating (SCOR) as having a 35 percent or higher probability of downgrade to "3" or worse, or

- identified in the Growth Monitoring System (GMS) as having a growth percentile of 98 or 99.

The FDIC also has a model that measures a bank's exposure to concentrations, the Real Estate Stress Test (REST). Eurobank was included on the ORL each quarter between September 30, 2005 and March 31, 2008, based on REST, GMS, and/or SCOR flags. Normal follow-up through continued offsite monitoring and scheduled onsite examinations was considered to be an appropriate supervisory strategy.

NYRO Supervisory Strategy for Puerto Rico

In March 2006, the NYRO Regional Risk Committee (RRC)[13] decided to include Puerto Rico as a unique risk area in its quarterly assessment due to emerging concerns associated

[13] FDIC's policy requires that each region have an RRC.

with economic and banking conditions in Puerto Rico. According to FDIC guidance, the mission of an RRC is to:

- review and evaluate regional economic and banking trends;
- develop follow-up strategies;
- allocate resources, where necessary, to implement follow-up strategies and actions; and
- prepare a regional matrix that summarizes the level of concern (i.e., magnitude of concern) and level of exposure (likely impact of adverse risk areas on the region's banking industry).

Beginning with the March 2006 report, the NYRO RRC quarterly summary reports reflect extensive discussions about economic conditions in Puerto Rico and planned supervisory strategies. In June 2007, the NYRO decided to develop a separate comprehensive supervisory strategy for Puerto Rico for the 2008 examination cycle because economic data revealed 4 consecutive quarters of job losses.[14] Further, the region's assessment of June 30, 2007 Call Report data showed signs of deterioration in the financial performance of banks in Puerto Rico.

Specifically, earnings performance had significantly declined during 2007 due to increased provision expenses associated with deterioration in asset quality. Puerto Rico banks historically reported a past due ratio for consumer loans that greatly exceeded the national median ratio. At the time, the NYRO was particularly concerned about the potential risks associated with consumer loans. Specifically, the region was concerned that overall growth in consumer lending in Puerto Rico, coupled with the extent of job losses, would lead to additional asset quality problems in the future. Over the period of 2004-2009, the national median past due ratio for consumer loans ranged from a low of 1.65 percent as of year-end 2006 to a high of 1.97 percent at year-end 2009. During the same time periods, the Puerto Rico banks reported a low of 3.73 percent in 2005 to a high of 6.95 percent in 2007. The increase in the Puerto Rico past due levels was of significant concern in 2006 as the Puerto Rico banks in aggregate had consumer loan exposure close to 100 percent of their capital.

According to the September 2007 RRC Summary Report, the region was also beginning to highlight trends in CRE and ADC concentrations in order to identify institutions with concentrations above supervisory thresholds defined in the December 2006 Joint Guidance. Concentrations were of heightened concern because Puerto Rico had lost jobs for more than 2 consecutive quarters, which may have been indicative of a recession. Further, the deteriorating trend showed signs of continuing.

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[14] Another area of concern related to accounting issues that were identified in 2005 and early 2006 requiring a number of Puerto Rico banks to restate financial statements. Eurobank was not involved in the restatement issue.

The *2008 NYRO Supervisory Strategy for Puerto Rico* captured (1) an overall view of identified risks for each of the banks; (2) a supervisory snapshot of each bank, including a summary describing each bank's primary business lines; and (3) resource needs. The supervisory strategy was comprised of a combination of point-in-time examinations, visitations, targeted reviews, horizontal reviews, and quarterly offsite analysis, with an emphasis on evaluating asset quality. The strategy was implemented on January 1, 2008 and updated for 2009.

Another aspect of the region's strategy involved regular communication with officials from Puerto Rico's Governor's offices, including the Government Development Bank (GDB), which operates in a role similar to that of a central bank to identify options for reducing the volume of non-performing assets on the island. Efforts were also made to jointly monitor economic conditions with GDB and OCFI to ensure effective communication in the event of one or more bank failures.

Supervisory Response to Key Risks

The overall financial condition of Eurobank was considered satisfactory in 2005 and 2006. However, beginning in 2006, examiners downgraded management for weaknesses in board oversight and operating management performance consistent with what is contemplated in the FDIC's forward-looking supervision program. Significant weaknesses existed in the BSA program, and numerous recommendations were made to improve risk management practices around the lending function. By 2007, the overall condition of the bank had begun to deteriorate and weaknesses in risk management practices remained uncorrected and more pronounced. As a result, examiners further downgraded component and composite ratings; made recommendations aimed at strengthening the bank's loan underwriting, credit administration, and funds management; and took progressively strong supervisory actions. Appendix 4 details examiners' comments related to key risks in examination reports issued from 2005 to 2008.

2005 Supervisory Activity

June Examination. Examiners concluded that the bank's overall financial condition was satisfactory and assigned Eurobank a composite "2" rating. Although the bank had experienced substantial growth over the past several years, the examination report noted that the Board took an active role in guiding the bank's affairs and was supported by a competent management staff. Further, management had adjusted the senior staff structure in line with the bank's growth. However, examiners lowered Eurobank's Capital component rating from a "1" to "2" based on the bank's increasing risk profile and growth plans.

Additionally, examiners considered Eurobank's risk management practices to be sound for all material areas except for an issue related to the bank's subprime automobile leasing program, which the Board addressed. The 2005 examination report also made recommendations related to the bank's internal loan review process and calculation of ALLL loss factors.

With respect to liquidity, examiners noted that Eurobank's net non-core funding dependency had risen. The examination report noted that funding with large brokered deposits from the U.S. was typical in Puerto Rico, and Eurobank's net non-core funding dependency was average for Puerto Rico banks. Examiners recommended that the bank begin performing liquidity stress tests to ascertain whether the bank could withstand a contraction in the brokered deposit market and improve Board reporting related to funds management.

2006 Supervisory Activity

August Examination. Examiners again assigned Eurobank a composite "2" rating. However, examiners downgraded the Management component rating to a "3" because of less than satisfactory Board oversight and operating management performance. Specifically, significant weaknesses existed in the BSA program, and numerous recommendations were made to improve risk management practices around the lending function. Despite an increase in adversely classified items and delinquent loans, asset quality was rated satisfactory. Classifications were concentrated in commercial credits and automobile leases, which represented 40 and 31 percent of total classified loans, respectively. Automobile leasing represented the highest net losses within the loan portfolio. The past due ratio had also increased to 6.14 percent from 5.24 percent at the prior examination.[15] The FDIC and OCFI concluded that the risk of material loss in the past due loans was mitigated because the majority were secured by chattel mortgages[16] on automobiles and real estate. Additionally, management had implemented a strategy to gradually reduce the bank's exposure to automobile leases, decreasing the portfolio by $38 million between August 2005 and September 2006. The level of capital remained satisfactory even though the bank's risk profile had increased slightly since the previous examination.

Liquidity also remained satisfactory and the examination report noted that the bank had implemented a new liquidity measurement system and recommended that management review current risk limits for liquidity and enhance its liquidity contingency plan and stress testing techniques. Further, the examination report stated that the bank maintained sufficient sources of secondary funding, including unsecured lines of credit and an overdraft line with the Federal Reserve Bank. The bank also increased its FHLB borrowing capacity during the examination.

2007 Supervisory Activity

Enforcement Action. Although management had initiated corrective action for many BSA-related apparent violations and previously identified weaknesses, the 2007 examination stated that Eurobank's system of internal controls for compliance with

[15] The number of past-due loans divided by the total number of current loans. This ratio is an indicator of the quality of a bank's loan portfolio.
[16] A mortgage on moveable goods or equipment. Chattel mortgages are often used for consumer credit financing of automobiles.

BSA/AML was inadequate for the third consecutive examination. Accordingly, the FDIC and OCFI pursued the BSA Order, which became effective on March 15, 2007.

October Examination. The 2007 examination found that the overall condition of the bank had deteriorated and concluded that the deterioration was a reflection on the Board and management's less than satisfactory performance. Consequently, examiners downgraded Eurobank to a composite "3" rating, signaling some degree of supervisory concern and indicating that management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Further, financial institutions with a composite "3" rating are generally less capable of withstanding business fluctuations and are more vulnerable to outside influences, and risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile.

As such, the 2007 examination report stated that Eurobank needed to improve risk management practices to better identify, measure, and control the risk to the bank. Multiple risk management weaknesses were identified, including deficiencies related to the bank's internal loan review and loan grading systems, funds management, and interest-rate risk management. Additionally, examiners stated that the bank's strategic plan needed to be revised to reflect more realistic asset growth expectations based on the bank's deteriorating condition and distressed economy.

The volume of adversely classified items also increased significantly between examinations, rising from $45.7 million (as of June 30, 2006) to $98 million (as of September 20, 2007). In addition, the classified items coverage ratio[17] increased to 47 percent from 26 percent reported at the 2006 examination. The past due ratio reflected an increasing trend for the third consecutive examination and delinquencies remained centered in loans secured by real estate and automobile leases. The automobile lease portfolio continued to generate the most losses within Eurobank's loan and lease portfolio. In general, the declining asset quality was attributed to the economic downturn and its impact upon certain borrowers. Examiners also found that Eurobank's net non-core funding dependency had increased, with brokered deposits continuing to be the bank's primary funding source, representing approximately 66 percent of total deposits. Notably, the examination report stated that the bank was fully dependent on the continued availability and roll-over of brokered deposits to cover scheduled maturities due to the large concentration of deposits maturing in the short-term and the limitation of additional sources of liquidity.

Examiner recommendations focused on improving the internal loan review function and enhancing the bank's monitoring of adherence to real estate lending standards. Internal loan review had failed to identify four construction loans classified Substandard by examiners; adversely classified construction loans represented 54 percent of total adversely classified loans, and these four loans represented two-thirds of total adversely classified construction loans. Recommendations were also made to strengthen liquidity policies, monitoring, and reporting, and to enhance the liquidity contingency plan

[17] This ratio is a measure of asset risk and the ability of capital to protect against risk.

because Eurobank's plan failed to define adverse factors that could impair the current liquidity position of the bank or include a stress test model.

With regard to the BSA Order, Board oversight in this area was found to be lacking, systems of internal control remained inadequate, and management failed to comply with provisions of the Order. Further, corrective actions noted in quarterly progress reports were found to be unsupported. Accordingly, the BSA Order remained in effect.

2008 Supervisory Activity

Enforcement Action. In addition to the BSA Order, on August 22, 2008, the Board adopted a BBR to address deficiencies disclosed in the 2007 examination. FDIC officials explained that the decision to accept the BBR, in lieu of entering into to a memorandum of understanding (MOU), was made after the exit meeting and took into consideration Eurobank's proactive stance and cooperation. According to the FDIC's *Formal and Informal Action Procedures Manual* (FIAP Manual), the FDIC may initiate informal action when a financial institution is found to be in a marginally unsatisfactory condition or to address specific concerns. Criteria outlined in the FIAP Manual states that a BBR may be appropriate if an institution's performance was of supervisory concern at a previous examination, but past corrective action has been successful and remaining concerns are minor. The FDIC generally uses an MOU instead of BBR when there is a reason to believe the deficiencies noted during an examination need a more structured program or specific terms to effect corrective action.

The BBR adopted by Eurobank required management to address: (1) apparent violations of rules and regulations related to the Puerto Rico Banking Law and apparent contraventions, (2) adversely classified commercial loans and nonaccrual and delinquent commercial loans, (3) credit risk management, (4) liquidity risk management policies in order to reduce dependence on volatile funding sources and expand secondary sources of liquidity and borrowing; and (5) capital levels to ensure that capital ratios remain *Well Capitalized* for PCA purposes. The BBR also required Eurobank to provide quarterly written progress reports.

August TAQR. The FDIC conducted its first TAQR of Eurobank in August 2008, which was completed in December 2008. The results of the review indicated that Eurobank's asset quality had continued to deteriorate. Specifically, adversely classified loans increased from 47 percent to 151 percent of Tier 1 Capital plus ALLL based on a 50-percent loan penetration. Examiners noted that problems manifested in the CRE loan portfolio were a result of the economic environment in Puerto Rico. Additionally, examiners concluded that there were numerous problems with the practices and procedures for the credit function. For example, management extended new funding for interest reserves on raw land loans; extended new funding for interest reserves on troubled ADC loans; extended new funding for interest reserves on collateral-dependent, troubled debt without obtaining new appraisals in violation of Part 323 of the FDIC Rules and Regulations (Part 323); extended unsecured, interest-only loans to principals of ADC projects where project interest reserves were depleted; relied upon nonconforming appraisals at loan origination in violation of Part 323; failed to track exceptions to interagency LTV limitations in nonconformance with *Real Estate Lending Standards*, Part 365 of the FDIC's Rules and Regulations; and failed to comply with the loan policy.

Although the parameters and methodology included in Eurobank's ALLL policy were satisfactory, the methods used by the bank to arrive at the "as is" or fair value of the underlying collateral of impaired loans were based on flawed assumptions. The bank's FASB 114 analyses were so flawed that examiners gave management a list of 13 properties, totaling $93 million, which required independent appraisals. Those appraisals were expected to be available for the scheduled "roll-up" examination set to begin on December 28, 2008. Based on the results of the TAQR, examiners recommended that Asset Quality be downgraded to a "4". As discussed later in this report, the FDIC and OCFI processed an interim composite downgrade in February 2009 based on the results of this TAQR and offsite monitoring.

December Examination. The results of the 2008 joint examination, transmitted to the bank on July 29, 2009, indicated that the overall financial condition of the bank continued to significantly deteriorate and was deemed unsatisfactory. With respect to the BSA Order, examination findings disclosed that the majority of management's assertions relative to corrective actions were inaccurate. Further, the examination report stated that the Board and management had not satisfactorily addressed provisions of the August BBR as evidenced by the deteriorated condition of the bank. In fact, several provisions had received little, if any, attention. The 2008 examination report noted that credit risk management practices were not improved, the budget process for 2009 relied on unrealistic assumptions, and a liquidity stress model was not developed.

The examination report stated that the Board and management's ability to effectively oversee the operations of the bank was questionable given the significant deficiencies related to the lending function, funds management, and BSA/AML compliance. Although the downturn in the economy was cited as a contributing factor to Eurobank's asset quality problems, the examination report stated that poor underwriting and inadequate credit administration problems contributed substantially to the bank's troubled condition. Examiners concluded that there were numerous problems with the practices and procedures for the lending function, particularly related to the ADC portfolio. The bank's capital levels were still *Well Capitalized* for PCA purposes, but the examination report noted that Eurobank's deteriorating condition was seriously impacting the bank's ability to withstand the pending effects of continued losses associated with the ADC portfolio and worsening economy.

Further, liquidity levels were determined to be inadequate to support weakening asset quality and the bank's poor financial condition. Core deposits had continued to decline, and dependence on brokered deposits and wholesale borrowings had increased. Examiners were particularly concerned about Eurobank's continued ability to roll over maturing brokered deposits, given adverse publicity, such as poor financial performance reports, which could result in resistance from deposit brokers. Further, although the Board had approved a Contingency Funding Plan on October 24, 2008, examiners determined that the plan was not appropriate for the size and risk profile of the institution.

The plan was general and focused on administrative details, and recommendations made at the previous examination to prepare cash flow projections and to test contingent funding plans were not addressed. Parameters to monitor liquidity stress events, such as the inability to roll over maturing brokered deposits, had not been finalized, and cash flow projections under any stress scenarios were not developed. The Liquidity Crisis Task Force, established by the plan, had not met, and procedures had not been tested as required.

2009 and 2010 Supervisory Activity

Interim Downgrades. During 2009, the FDIC processed two interim downgrades. First, on February 13, 2009, the FDIC notified the bank that it was being downgraded from a composite “3” to a “4” based on an offsite assessment of the bank’s December 31, 2008 Call Report and the findings of the August 2008 TAQR. In addition, the FDIC formally notified the bank of its “troubled condition,” which imposed certain requirements with respect to management changes and severance plans. Specifically, the bank had to notify the FDIC in writing at least 30 days prior to certain management changes. Additionally, the bank was required to file an application to obtain the FDIC’s consent prior to (1) entering into any agreement to pay and (2) making any golden parachute payment or excess nondiscriminatory severance plan payment to any institution-affiliated party. The second interim rating change was based on a review of Eurobank’s September 30, 2009 Call Report and preliminary findings of the September 2009 TAQR. The Capital, Asset Quality, and Earnings component ratings and the composite rating were downgraded to a “5” in December 2009.

Enforcement Actions. The BSA Order remained in effect. The FDIC and OCFI also issued a C&D on October 9, 2009, based on the results of the December 2008 examination. The C&D included provisions aimed at addressing cited deficiencies, including Board oversight, management’s qualifications, loan policies and procedures, lending and credit administration, the appraisal compliance program, classified assets, ALLL, and funds management. The C&D also included a capital maintenance requirement, which is discussed later in this report.

Further, after the completion of the onsite portion of the December 2008 examination, the FDIC sent Eurobank a letter on April 29, 2009 to convey supervisory expectations and to inform the bank that a formal corrective action was being recommended. The letter stated that the bank was required to obtain a non-objection from the FDIC before engaging in any transactions that materially changed the bank’s balance sheet composition, including growth in total assets or significant changes in funding sources.

September TAQR. The second TAQR commenced on September 28, 2009 and was completed in April 2010. FDIC officials explained that the scope of the review covered the entire loan portfolio and proved to be challenging because most account officers were unable to provide pertinent information or respond to examiner inquiries during loan discussions. In many instances, examiners stated that they were more familiar with the credits and related collateral than the lending staff. Further, the bank’s lack of sufficient staff with adequate lending skills made it difficult, if not impossible, for the bank to effectively monitor and work out troubled loans. For example, the bank's ADC portfolio consisted of 72 loans, which were mostly problematic and being handled by only one loan officer.

Based on the preliminary TAQR findings, it appeared that the bank would become *Critically Undercapitalized*. FDIC officials informed us that the results of the TAQR were analyzed closely in early 2010 because of the significant difference between examiners' and the banks' internal classifications at Eurobank, Westernbank, and R-G Premier. While examiners were completing the TAQR, examiners conducted a horizontal review in January 2010 to ensure that classifications of CRE loans at these three banks were consistent. Ultimately, based on the results the TAQR, Eurobank's capital levels fell to *Critically Undercapitalized* after the bank increased the ALLL and provision expense to reflect those results.

Brokered Deposit Waivers. On August 6, 2009, the FDIC notified the Board that the bank was designated *Adequately Capitalized* based on the filing of the bank's June 30, 2009 Call Report, prompting the need for a brokered deposit waiver. Additionally, the October 2009 C&D included a capital provision, which by definition lowers an otherwise *Well Capitalized* institution to *Adequately Capitalized*. The FDIC approved three brokered deposit waivers between October 2009 and March 2010, as follows:

- **October 9, 2009**. The FDIC approved a limited broker deposit waiver request submitted in August 2009 allowing Eurobank to renew and/or roll over brokered deposits that matured through November 30, 2009.

- **December 30, 2009**. The FDIC approved a second limited brokered deposit waiver, which allowed the bank to renew and/or roll over brokered deposits maturing through March 21, 2010.

- **March 29, 2010.** The FDIC approved a third limited broker deposit waiver allowing Eurobank to renew and/or roll over 75 percent or up to $27 million of brokered deposits that matured in April 2010. The waiver notification also stated that the waiver would terminate immediately if the bank became less than *Adequately Capitalized* under PCA guidelines.

In each case, the FDIC concluded that the brokered deposit waiver would not result in an unsafe or unsound practice. In general, the waivers were for 90-day periods and limited Eurobank to issuing or rolling over approximately 40 percent of maturing broker deposits. In addition, on November 9, 2009, Eurobank submitted to the FDIC its *Funds Management and Liquidity Plan* that described the bank's planned reduction of brokered deposits. Eurobank provided an updated plan on December 8, 2009. According to Part 325 of the FDIC's Rules and Regulations,[18] a bank is deemed to be within a given capital category for purposes of section 38 of the FDI Act as of the most recent date:

[18] For purposes of section 29 of the FDI Act and section 337.6, the terms *Well Capitalized, Adequately Capitalized,* and *Undercapitalized,* have the same meaning as to each insured depository institution as provided under regulations implementing section 38 of the FDI Act.

- a Call Report is required to be filed with the FDIC;
- a final report of examination is delivered to the bank; or
- written notice is provided by the FDIC to the bank of its capital category for purposes of section 38 of the FDI Act.

In this case, the FDIC did not hold an exit meeting with management to discuss findings of the 2009 examination until April 28, 2010 and, at that time, hand-delivered a letter notifying the bank of its new PCA Capital category, *Critically Undercapitalized,* and related brokered deposit restrictions.

Supervisory Lessons Learned

According to the FDIC's *Risk Management Manual of Examination Policies* (Examination Manual), the quality of an institution's management, including its Board of Directors and executive officers, is perhaps the single most important element in the successful operation of a bank. The Board has overall responsibility and authority for formulating sound policies and objectives for the bank and for effectively supervising the institution's affairs. The Examination Manual further states that:

> …to effectively prevent serious problems in an institution, the conditions and circumstances that may lead to problems must be identified and corrected early. Corrective action should be taken immediately upon identifying excessive risk taking…when corrective action is not taken until conditions have deteriorated it is often too late to avoid failure. Moral suasion and informal agreements are normally sufficient where the unacceptable risk-taking is identified early, but formal action must be considered, even when an institution is rated 1 or 2, if circumstances warrant.

The FDIC downgraded Eurobank's component ratings in the 2006 examination and further downgraded the bank in 2007, accepting a BBR adopted by the Board following the examination to address identified deficiencies. However, the Board and management did not satisfactorily address provisions of the BBR and, consequently, the FDIC progressively downgraded the bank and took stronger enforcement action to secure correction of weaknesses in risk management practices in subsequent examinations. In hindsight, pursuing an MOU following the 2007 examination may have been more effective in obtaining management's commitment and follow-through to address deficiencies identified by examiners. A more structured supervisory action may have been called for considering the Board and management's inadequate response to BSA-related actions. Additionally, the FDIC could have required Eurobank to increase its capital levels above what is minimally required for a bank to maintain a *Well Capitalized* level. These steps may have served to limit the amount of loss that was experienced on the work-out of the troubled ADC credits.

In addition, stronger attention to Eurobank's increasing dependence on brokered deposits may have been prudent. Specifically, examiners made repeated recommendations to bank management to strengthen its liquidity stress testing and liquidity contingency plan. Additional emphasis in the form of an informal enforcement action might have been beneficial in prompting the bank to take earlier action to reduce its dependence on this funding and be equipped to remain viable in a declining economy and real estate market.

The FDIC has taken a number of actions to increase supervisory attention to banks that have risk profiles similar to Eurobank. Of note, in March 2010, the FDIC completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The FDIC has also issued updated guidance to examiners regarding CRE loan examination procedures in view of more challenging market conditions, particularly in ADC lending, and supervisory expectations for FDIC-supervised institutions to update real estate appraisals and evaluations.

In August 2008, the FDIC issued FIL-84-2008, entitled, *Liquidity Risk Management*, which stresses the importance of contingency funding plans for institutions that use wholesale funding sources, including brokered deposits. In addition, in March 2009, the FDIC issued FIL 13-2009, entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions that are in Weakened Condition*. FIL 13-2009 states that FDIC-supervised institutions having a composite rating of "3," "4," or "5" are expected to establish and implement appropriate plans to mitigate the risks associated with the use of potentially volatile liabilities.

Implementation of PCA

Section 38, Prompt Corrective Action, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of Capital Restoration Plans (CRP) and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to Eurobank, the FDIC properly implemented applicable PCA provisions of section 38. Among other things, the FDIC formally notified the bank when its capital category changed, reviewed and monitored the institution's Call Report and liquidity reports; and conducted periodic discussions with management regarding plans to raise capital and compliance with PCA restrictions, including associated restrictions on brokered deposits as discussed previously in this report. Table 4 illustrates the significant decline in Eurobank's capital levels from 2005 to 2009.[19]

Table 4: Eurobank's Capital Levels, 2005 to 2009

Exam/Visit Date	Tier 1 Leverage	Tier 1 Risk-Based	Total Risk-Based	Capital Classification
Well-Capitalized Threshold	≥ 5%	≥ 6%	≥ 10%	
6/6/2005 Joint Examination	6.6	8.38	10.56	*Well Capitalized*
8/31/2006 Joint Examination	6.47	8.4	10.43	*Well Capitalized*
10/29/2007 Joint Examination	7.29	8.93	10.08	*Well Capitalized*
12/29/2008 Joint Examination	6.81	9.41	10.66	*Well Capitalized*
6/30/2009 Call Report	5.66	8.46	9.71	*Adequately Capitalized*
9/30/2009 Call Report	5.50	8.81	10.06	*Well Capitalized**
9/28/2009 Joint TAQR**	0.53	0.87	1.74	*Critically Undercapitalized*

Source: Examination reports, TAQRs, and Call Reports for Eurobank.
*Once Eurobank became subject to a C&D that addressed the capital level on October 9, 2009, by definition, the bank became *Adequately Capitalized.*
**Results complete in April 2010.

Eurobank was considered *Well Capitalized* for PCA purposes until August 2009, when the bank fell to *Adequately Capitalized* based on its June 30, 2009 Call Report, and subsequently as a result of the October C&D that included a capital maintenance provision. With respect to capital, the C&D directed Eurobank to:

- on or before December 31, 2009, increase and maintain a Tier 1 Leverage Capital ratio equal or above 6.5 percent and a Total Risk-Based Capital ratio equal or above 11 percent; and

- on or before March 31, 2010, increase and maintain a Tier 1 Leverage Capital ratio above 7 percent and a Total Risk-Based Capital ratio above 11 percent.

The C&D also required Eurobank to develop a plan within 30 days of the C&D to reduce its reliance on non-core funding and high-cost, rate-sensitive deposits and set forth funding sources that would replace the Bank's current brokered deposits as they matured. The FDIC's efforts to monitor Eurobank's capital position and the bank's response to the C&D included the following:

- **January 26, 2010.** The FDIC sent a letter to Eurobank notifying the bank that its December 31, 2009 Call Report capital ratios were less than those required by the C&D and, therefore, the bank was required to submit a plan to increase capital ratios within 30 days.

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[19] Eurobank had submitted an application for the Troubled Asset Relief Program on November 10, 2008 for funding of $60 million; however, the bank subsequently withdrew its application on June 1, 2009.

- **February 1, 2010.** Eurobank officials met with FDIC officials to discuss the bank's capital-raising prospects.

- **April 1, 2010.** Eurobank presented its capital plan to the FDIC and OCFI.

- **April 16, 2010.** The FDIC sent a letter notifying Eurobank that the bank's capital plan presented on April 1, 2010 was rejected and advised Eurobank that it needed to immediately provide its recapitalization plan or sell/merge with another federally insured depository institution.

On April 28, 2010, the FDIC notified Eurobank that it had fallen to *Critically Undercapitalized* based on TAQR findings. The FDIC's PCA notification letter outlined restrictions pursuant to Part 325 of the FDIC's Rules and Regulations. Eurobank was restricted from accepting, renewing, or rolling over any brokered deposits, and waivers from this prohibition were unavailable. Although the letter required Eurobank to submit a capital restoration plan within 45 days of the date of the letter, regulators had already concluded that Eurobank was unable to raise the level of capital required. Within 2 days of the PCA letter, OCFI closed Eurobank on April 30, 2010.

Corporation Comments

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On December 2, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 5 of this report. DSC reiterated the OIG's conclusions regarding the causes of Eurobank's failure. With regard to our assessment of the FDIC's supervision of Eurobank, DSC described its supervisory approach and actions taken in response to weaknesses in the bank's risk management practices, including rating downgrades and use of enforcement actions between 2006 and 2010, as discussed in our report. DSC's response noted that Eurobank's Board and management failed to adequately address supervisory recommendations and enforcement measures. Further, DSC's response stated that supervisory guidance has been issued to enhance supervision of institutions, such as Eurobank, that rely heavily on volatile funding sources. In addition, DSC stated it has completed an examiner training program, as discussed in our report, which emphasizes a forward-looking approach when assessing a bank's risk profile. The early use of informal enforcement actions to pursue corrective of weak risk management practices is consistent with forward-looking supervision.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, as amended by the Financial Reform Act, which provides, in general, that if the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The Financial Reform Act amends section 38(k) of the FDI Act by increasing the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38.

We conducted this performance audit from July 2010 to November 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of Eurobank's operations from December 31, 2005 until its failure on April 30, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

To achieve the objectives, we performed the following procedures and techniques:

- Analyzed examination reports prepared by the FDIC and the OCFI examiners from 2005 to 2009.

- Reviewed the following:

    - Bank data and correspondence maintained at the FDIC New York Regional Office and San Juan, Puerto Rico, Field Office.

    - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.

    - Pertinent DSC policies and procedures and various banking laws and regulations.

Objectives, Scope, and Methodology

- Interviewed the following FDIC officials:

    - DSC management in Washington, D.C., the New York Regional Office, and San Juan, Puerto Rico Field Office.

    - FDIC examiners from the Jamesburg, New Jersey and San Juan Puerto Rico Field Offices, who participated in examinations or reviews of examinations of Eurobank.

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance with Laws and Regulations

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, ROEs, and interviews of examiners to understand Eurobank's management controls pertaining to causes of failure and material loss as discussed in the body of this report.

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including ROEs, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests were discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related

Objectives, Scope, and Methodology

recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions and these reports can be found at www.fdicig.gov. In June 2010, the OIG initiated an audit, the objectives of which are to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

In addition, with respect to more comprehensive coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and that provide interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Bank Board Resolution (BBR)	A Bank Board Resolution is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Bank Secrecy Act (BSA)	Congress enacted the BSA of 1970 to prevent banks and other financial service providers from being used as intermediaries for, or to hide the transfer or deposit of money derived from, criminal activity. The BSA requires financial institutions to maintain appropriate records and to file certain reports, including cash transactions over $10,000 via the Currency Transactions Reports (CTR). These reports are used in criminal, tax, or regulatory investigations or proceedings.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.

Glossary of Terms

Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. section 1818 to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Contingency Funding (or Liquidity) Plan	A written plan that defines strategies for addressing liquidity shortfalls in emergency situations. Such plans delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. Contingency funding plans should be regularly tested and updated to ensure that they are operationally sound. DSC uses the term contingency funding plan and contingency liquidity plan interchangeably.
FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.
Federal Home Loan Bank (FHLB)	FHLBs provide long- and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans, and government and agency securities. Community financial institutions may pledge small business, small farm, and small agri-business loans as collateral for advances. Advances are priced at a small spread over comparable U.S. Department of the Treasury obligations.

Glossary of Terms

Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: guarantor's related debt at other financial institutions, future economic conditions, as well as obtaining current and complete operating statements of all related entities. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with a particular loan.
Growth Monitoring System (GMS)	GMS is an offsite rating tool that identifies institutions experiencing rapid growth or having a funding structure highly dependent on non-core funding sources.
Loan-to-Value	A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Nonaccrual Status	The status of an asset, often a loan, which is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status.
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.

Glossary of Terms

Problem Bank Memorandum	A problem bank memorandum documents the FDIC's concerns with an institution and the corrective action in place or to be implemented and is also used to effect interim rating changes on the FDIC's systems.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Real Estate Stress Test (REST)	REST attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that of New England in the early 1990s. REST uses statistical techniques to forecast an institution's condition over a 3- to 5-year horizon and provides a single rating from 1 to 5 in descending order of performance quality.
Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC's Rules and Regulations. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).
Special Mention Assets	A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.
Statistical CAMELS Offsite Rating (SCOR) System	SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.

Glossary of Terms

Substandard	One of three types of classifications used by examiners to describe adversely classified assets. The term is generally used to describe an asset that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard assets are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Department of the Treasury to purchase assets and equity from financial institutions to strengthen the financial sector.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Glossary of Terms

Wholesale Funding	Wholesale funding sources include, but are not limited to, Federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or CD listing services. Financial institutions may use wholesale funding sources as an alternative to core deposits to satisfy funding and liability management needs.

Acronyms

ACI	Adversely Classified Item
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
AML	Anti-Money Laundering
BBR	Bank Board Resolution
BSA	Bank Secrecy Act
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FAS	Financial Accounting Standards
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GDB	Government Development Bank
GMS	Growth Monitoring System
LTV	Loan-to-Value
MLR	Material Loss Review
MOU	Memorandum of Understanding

Acronyms

NYRO	New York Regional Office
OIG	Office of Inspector General
OCFI	Office of Commissioner of Financial Institutions
ORL	Offsite Review List
PCA	Prompt Corrective Action
PRIC	Puerto Rico Investment Companies
REST	Real Estate Stress Test
ROE	Report of Examination
RRC	Regional Risk Committee
SCOR	Statistical CAMELS Offsite Rating
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
U.S.	United States

Examiner Comments in Reports of Examination

ROE Dates	2005	2006	2007	2008
Deficiency/Risk				
Concentration in Automobile Leasing	✓	✓		
Concentration in CRE Loans	✓	✓		✓
Concentration in ADC Loans				✓
Inadequate/Enhance Loan Underwriting				
Subprime lending activity	✓		✓	
LTV Exceptions			✓	✓
Liberal Use of Interest Reserves				✓
Weak/Enhance Credit Administration				
Inadequate Loan Policy	✓		✓	✓
Inadequate Capital for Subprime Lending	✓			
Inadequate Internal Loan Review and Grading System	✓	✓	✓	✓
Inadequate ALLL Policy and Procedures		✓	✓	✓
Inadequate Collections Policies			✓	✓
Inadequate Disposition of Assets			✓	✓
Lack of Current Appraisals				✓
Lack of Segregation in Lending and Loan Administration Functions			✓	
Violations or Contraventions				
Legal Lending Limit - Puerto Rico Banking Law Section 17 (a) and (d)		✓		
Part 323-Appraisal Violation				✓
Part 365-Interagency Guidelines for Real Estate Lending Policies			✓	✓
Guidance on Concentrations in CRE				✓
Recommendations				
Improve Internal Loan Review Function	✓	✓	✓	
Improve Underwriting/Credit Administration Procedures	✓	✓		✓
Improve Identification of Subprime Loans and Establish Risk Tolerance	✓		✓	
Improve Lending Policies			✓	✓
Asset Losses				
Significant Loan Deterioration			✓	✓

Source: Examination reports for Eurobank.

Corporation Comments

FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Supervision and Consumer Protection

December 1, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson [signed by Sandra L. Thompson]
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of Eurobank, San Juan, Puerto Rico (Assignment No. 2010-067)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Eurobank, San Juan, Puerto Rico, which failed on April 30, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on November 10, 2010.

Eurobank failed because the Board and management did not effectively oversee and appropriately react to Puerto Rico's prolonged and severe recession, particularly with respect to Eurobank's commercial real estate and acquisition, development and construction loan portfolios. Management mishandled the administration of these loan portfolios as the economy deteriorated, real estate sales slowed, and loans became delinquent. Weaknesses in Eurobank's internal loan grading system, appraisal review process, and underwriting of renewals and extensions exacerbated losses. Erosion of capital associated with loan losses restricted and eventually prohibited Eurobank from renewing brokered deposits, which it relied upon for operational funding. Ultimately, Eurobank was not considered viable because of its deteriorating asset quality, poor earnings and declining capital.

The FDIC's supervisory attention to Eurobank from 2005 to 2010 was extensive, and included onsite joint annual examinations with the Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico (OCFI), offsite monitoring activities and targeted asset quality reviews. Weaknesses in risk management practices first led to a management component downgrade to "3" in 2006. Weaknesses were repeated and more pronounced in the 2007 and 2008 examinations, and the FDIC and OCFI progressively downgraded component and composite ratings and used enforcement actions to secure Eurobank's correction of deficiencies. Eurobank's Board and management failed to adequately address supervisory recommendations and enforcement measures.

DSC issued a Financial Institution Letter in 2009 on *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition* to enhance our supervision of institutions, such as Eurobank, with heavy reliance on volatile funding sources. Additionally, DSC has completed an examiner training program that emphasizes a forward looking approach when assessing a bank's risk profile. The training reinforced consideration of risk management practices in conjunction with current financial performance, conditions, or trends when assigning ratings and contemplating corrective actions. The early use of informal enforcement actions to pursue correction of weak risk management practices is consistent with forward looking supervision.

Thank you for the opportunity to review and comment on the Report.