

**Decision of the  
Supervision Appeals Review Committee**

**In the Matter of \* \* \***

**Case No. 2016-03**

***I. Summary of Findings***

After consideration of the timely filed written submissions of the parties, the record of this case, and following the January 11, 2017 deliberative meeting of this Committee, we have denied the Bank's appeal. For reasons set forth below, the Committee upholds the decision of the Director of the Division of Risk Management Supervision affirming supervisory determinations made during the \* \* \*, 2015 joint examination. These determinations are consistent with FDIC policy and practices and are well-supported by the facts and issues documented in the record.

***II. Procedural History***

This appeal concerns material supervisory determinations arising from the examination of \* \* \* ("Bank"), which began on \* \* \*, 2015 and was conducted jointly by the FDIC's \* \* \* Regional Office and the [State banking authority]. The joint examination resulted in CAMELS ratings of 233321/3.<sup>1</sup> The Report of Examination ("Report") also included an IT assessment and rating of "2." The Report noted, in particular:

- Asset quality was less than satisfactory, despite reductions in adversely classified assets, adversely classified other real estate owned ("OREO"), and delinquency levels;
- Earnings performance improved from the previous examination but remained less than satisfactory due to costs associated with the Bank's funding structure and its moderately high volume of non-performing loans and foreclosed real estate; and
- Further action was required to achieve full compliance with three outstanding provisions of a joint Memorandum of Understanding dated \* \* \*, 2013 ("MOU").

The Bank filed a Request for Review with the Director of the Division of Risk Management Supervision ("RMS") on August 18, 2016, contesting the Composite rating and the Asset Quality, Earnings, and Management component ratings. On October 5, 2016, the Division Director issued her decision concurring with the assigned ratings.

The Bank timely filed an appeal with the Supervision Appeals Review Committee by letter dated November 3, 2016. In accordance with the *Guidelines for Appeals of Material Supervisory Determinations* ("Guidelines"),<sup>2</sup> the Committee has reviewed the Bank's appeal for consistency with the policies, practices, and mission of the FDIC, and the reasonableness of and support for

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<sup>1</sup> Capital "2," Asset Quality "3," Management "3," Earnings "3," Liquidity "2," Sensitivity to Risk "1," and Composite "3."

<sup>2</sup> 77 Fed. Reg. 17,055 (Mar. 23, 2012) (available at <http://www.fdic.gov/regulations/laws/sarc/sarcguidelines.html>).

the positions of the parties. The Committee met to consider the appeal and hear oral presentation from the parties on January 11, 2017. The Committee has carefully considered the written submissions and oral presentations of the parties.

Under the *Guidelines*, the Committee's review is limited to the facts and circumstances as they existed prior to or at the time the relevant material supervisory determinations were made. No consideration is given to any facts or circumstances that occur or corrective actions taken after the determinations were made.

### ***III. Preliminary Discussion***

The Bank has acknowledged that it has adopted a high-risk business plan to provide financing to a targeted set of customers. The Bank specializes in lending to start-up businesses and distressed small businesses. Its underwriting process attempts to mitigate the risks associated with these loans in two ways. First, the Bank emphasizes collateral instead of the borrower's cash flow. As a result, many of the Bank's loans are collateralized by real estate. Second, the Bank seeks to obtain government loan guarantees, such as the guarantees available through the Small Business Administration's loan programs.

The Bank also monitors portfolio loan risk through standing weekly meetings where problem loans are discussed and evaluated. During these meetings, which include senior management and several members of the Bank's board of directors, participants discuss the status of each loan and recommendations for mitigating risk, arriving at a consensus as to a course of action.

The foundation of this appeal is the contention that the examiners' tools and methods did not sufficiently account for the Bank's unique business plan, which by its nature entails elevated loan delinquencies, expenses, and foreclosures. The Bank asserts that the examiners failed to give sufficient consideration to its proactive risk mitigation strategies and its sound long-term charge-off history and capital position. The Bank has argued that comparing its past due loan levels, OREO levels, and other metrics "with 'peers' or with normal regulatory standards does not yield accurate measurements of risk."<sup>3</sup> The Bank contends that the FDIC should "accept the Bank's proven accurate asset quality measurements and evaluations," such as the net loan risk metric that the Bank has developed, rather than apply the standard metrics used in examining institutions across the industry.<sup>4</sup> As these arguments involve broader questions on the purpose and nature of bank supervision, the Committee believes that some context may be helpful.

Deposit insurance enhances public confidence in the banking system, making insured banks more attractive to depositors and enabling them to obtain funding at a lower cost.<sup>5</sup> To promote stability and public confidence, and to protect the Deposit Insurance Fund, insured institutions are subject to safety and soundness supervision.<sup>6</sup>

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<sup>3</sup> Bank's Request for Review, p. 2.

<sup>4</sup> Bank's Request for Review, p. 3.

<sup>5</sup> See Risk Management Manual of Examination Policies § 1.1-2, "Rationale of Bank Examinations" (available at <https://www.fdic.gov/regulations/safety/manual/>).

<sup>6</sup> See Risk Management Manual of Examination Policies § 1.1-2, "Rationale of Bank Examinations"; see also FDIC 2015-2019 Strategic Plan, "Mission, Vision, and Values" (available at <https://www.fdic.gov/about/strategic/strategic/mission.html>).

As the insurer of bank deposits, the FDIC is particularly attuned to how changes in the economy, the financial markets, and the banking system affect the adequacy and viability of the Deposit Insurance Fund.<sup>7</sup> A forward-looking approach to supervision not only protects the Fund and, by extension, the public; it also benefits banks by promoting the early identification and correction of serious problems that could lead to failure.<sup>8</sup> Bank examinations identify undue or emerging risks and weak risk management practices at insured banks.<sup>9</sup> Prudence requires examiners to consider a variety of risks to ensure that banks can withstand unexpected changes in business conditions over the full course of an economic cycle.<sup>10</sup> Thus, while the examiners must consider the Bank's historical performance concerning capital and other metrics, this complements – and cannot replace – the anticipatory aspects of their analysis.

An effective supervisory framework requires consistent application of principles and policies across banks. This ensures fairness and the allocation of supervisory resources to banks that warrant elevated attention.<sup>11</sup> The FDIC and other bank regulators promote consistent supervision through, among other things, common standards for rating banks and reporting on their financial condition. The Committee cannot condone deviations from regulatory reporting standards or the use of unique metrics or methods to evaluate the Bank. Doing so would undermine supervisory consistency and could lead to the neglect of serious weaknesses in the Bank's condition. The FDIC's standard examination methods and metrics allow examiners to perform fair, consistent, and thorough evaluations across different types of banks. Examinations include qualitative and quantitative assessments to provide a comprehensive evaluation of a bank's condition and performance, regardless of its particular strategy.<sup>12</sup> If the Bank effectively manages the risks of its chosen strategy, the broad variety of metrics and assessments used by examiners will reflect that result.

The Report appears to provide a balanced assessment of the Bank's condition, recognizing strengths and improvements from the prior examination but also pointing to legitimate weaknesses that must be addressed. The disputed examination ratings do not seem to be the result of shortcomings or blind spots in the supervisory framework; rather, they reflect the Bank's failure to adequately manage the risks inherent in its business model. The Committee also has concerns about the Bank's ability to withstand potential adverse changes in economic conditions, and notes that even the Bank's preferred measures relating to capital and charge-offs have not strengthened to the extent that generally would be expected in an improving environment.

#### ***IV. Analysis***

The Bank contests its assigned Asset Quality, Earnings, and Management component ratings, as well as its Composite rating.

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<sup>7</sup> For example, *see* 2015 FDIC Annual Report, p. 19.

<sup>8</sup> *See* Risk Management Manual of Examination Policies § 1.1-9, "Anticipatory Supervision."

<sup>9</sup> Risk Management Manual of Examination Policies § 1.1-2, "Rationale of Bank Examinations."

<sup>10</sup> *See* Risk Management Manual of Examination Policies § 1.1-9, "Anticipatory Supervision."

<sup>11</sup> *See Uniform Financial Institutions Rating System*, 62 Fed. Reg. 752 (Jan. 6, 1997).

<sup>12</sup> *See Supervisory Insights*, Summer 2012, "The Risk Management Examination and Your Community Bank" (available at <https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum12/examinations.html>).

## ***A. Asset Quality Rating***

### ***The Bank's Position***

The Bank argues that its Asset Quality component rating of “3” should be upgraded to “2.”

According to the Bank, the examiners’ methods and metrics for evaluating asset quality cannot accurately gauge the risks associated with its unique business plan, which naturally results in elevated loan delinquencies, expenses, and foreclosures. The Bank contends that the examiners failed to sufficiently consider its risk mitigation strategies – emphasis on collateral protection and government loan guarantees. The Bank believes that its history of charge-offs proves the effectiveness of these strategies and provides a more accurate assessment of asset quality.

The Bank also takes issue with the examiners’ criticisms regarding its foreclosed real estate. The Bank explains that while it experienced problems a few years ago with its infrastructure and processes relating to foreclosed real estate, those issues have been addressed, resulting in healthy sales activity. The Bank asserts that it sold \$11 million in OREO during the past three years at 98% of appraised value, but this accomplishment was discounted in the examiners’ analysis. In the context of its business plan, the Bank believes that its asset quality is satisfactory, warranting a “2” Asset Quality rating.

### ***RMS's Position***

RMS argues that the evaluation of asset quality must consider more than the Bank’s historical loss experience, and the examiners’ broader assessment of the Bank found less than satisfactory asset quality. Levels of classified assets and delinquent and nonaccrual loans showed some improvement from the last examination, but remained elevated. RMS also noted concentrations in commercial real estate, including segments that are experiencing significant delinquency. Management has not fully complied with the \* \* \* 2013 MOU’s credit risk provisions, which require reductions in adverse classifications, OREO, and nonaccrual loans, as well as proper Call Report treatment of nonaccrual loans.

According to RMS, the examiners recognized improvements to the Bank’s OREO processes and reductions in OREO inventory, but legitimate concerns remain. The examiners recognized that two OREO properties were under contract at the time of the examination, and those sales were expected to reduce holdings by approximately \$2.5 million. However, the Bank’s portfolio included twenty-two properties with a total carrying value of approximately \$6,151,000, with adversely classified OREO totaling nearly \$3,491,000. Fifteen of these properties had been held for more than three years, and several had little sales activity. In addition, the examiners noted two instances where the Bank’s accounting for financed sales of OREO was inconsistent with generally accepted accounting principles and the Call Report Instructions. RMS asserts that these concerns support the assigned rating.

### ***The Committee's Findings***

The Uniform Financial Institutions Rating System (“UFIRS”) provides the following guidance on the Asset Quality component rating:

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the exposure to counterparty, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.<sup>13</sup>

A "2" rating "indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities."<sup>14</sup>

A "3" rating "is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices."<sup>15</sup>

The Bank's strategic focus on lending to start-ups and distressed small businesses does not require the examiners to use a different metrics or tools in evaluating asset quality. As explained above, a consistent examination approach promotes fair and effective supervision, and the assessment is sufficiently comprehensive to address collateral-dependent loans and government guarantees. The examiners considered the Bank's risk mitigation strategies, as the Report states that loan guarantees applied to less than a third of the Bank's portfolio, and the analysis of specific loans includes guarantees and the value of supporting collateral.

The importance of using a variety of metrics and tools to evaluate asset quality is particularly apparent in this case. Considering asset concentrations and metrics such as the percentage of delinquent loans promotes a broad view of credit risk in the portfolio, while loan classifications account for the risks of particular loans and the mitigating effects of guarantees and collateral protection. In combination, these tools enable examiners to make the comprehensive assessment of asset quality required by UFIRS.<sup>16</sup>

The Report's findings concerning the Bank's foreclosed real estate appear to reflect a balanced assessment by the examiners. The Report recognizes improvements to the Bank's OREO

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<sup>13</sup> 62 Fed. Reg. 754.

<sup>14</sup> 62 Fed. Reg. 754.

<sup>15</sup> 62 Fed. Reg. 754.

<sup>16</sup> UFIRS provides that the assessment of a bank's asset quality is based on, among other things: the adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices; the level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions; the existence of asset concentrations; the adequacy of loan and investment policies, procedures, and practices; and the ability of management to properly administer its assets. *See* 62 Fed. Reg. 754.

processes and reductions in OREO inventory, including sales that closed after the on-site portion of the examination was completed. However, it also notes that the Bank has held fifteen of its remaining twenty-two OREO properties for more than three years, and many of these properties have had few reasonable purchase offers. In addition, the Report describes an analysis of the Bank's historical OREO sales demonstrating escalating losses as properties are held for longer periods of time. While the Bank's efforts with respect to foreclosed real estate have had some effect, its OREO holdings continue to present substantial risk.

The Bank's contention that it has consistently sold OREO properties at 98% of appraised value over the last three years does not squarely address these concerns. That fact may demonstrate that the Bank's disposition process effectively realizes the current appraised value of properties, but it does not reflect full recovery of the Bank's investment, which may be eroded by valuation write-downs and capitalized improvements. The Report documents that over the past two years, the Bank sold thirty-eight properties at an average of 15% below the original acquisition appraised value plus capitalized improvements. This presents a significant risk to the Bank, given its focus on making higher-risk loans protected by real estate collateral.

The Committee does not believe that the Bank's asset quality has returned to a satisfactory state. While levels of classified assets and delinquent and nonaccrual loans showed improvement from the last examination, they remain elevated and are roughly unchanged from levels at the Bank's 2013 examination. OREO holdings continue to present substantial risk, concentrations remain a concern, and additional efforts are required to fully comply with the credit risk provisions of the MOU. The Committee concludes that the assigned Asset Quality rating is well-supported.

## ***B. Earnings Rating***

### ***The Bank's Position***

The Bank argues that its Earnings component rating of "3" should be upgraded to "2."

The Bank argues that its business plan results in elevated revenue and expenses when compared with the traditional community bank business model, but the examiners failed to sufficiently consider the incremental revenue.

The Bank also notes certain instances where it was not permitted to accrue interest income with respect to delinquent loans or sales of foreclosed real estate. The Bank argues that in each case, its judgment was later validated. In the Bank's view, this resulted in substantial understatement of its revenue and earnings.

The Bank believes that the examiners mistakenly viewed certain infrastructure investments, such as planned expansions to its facilities and staff, as relating to asset quality. The Bank contends that these expenses were necessary to support future growth and should be considered in that light.

The Bank also argues that the examiners effectively penalized it for its choice of business model by focusing on the cost of brokered deposits in comparison to a traditional retail deposit funding

structure. The Bank contends that the examiners emphasized this aspect of its cost structure and ignored other relevant considerations, such as the duration of deposits and retail overhead.

The Bank asserts that its earnings over the last decade have been sufficient to maintain or improve capital and pay dividends, despite substantial investments in infrastructure and compliance with the examiners' judgment concerning revenue recognition. The Bank believes that this sustained performance merits an upgrade to a "2" rating.

### ***RMS's Position***

RMS explains that the examiners accounted for both incremental revenue and expenses by using metrics such as return on average assets ("ROA"), which is based on the Bank's net income. According to RMS, revenue did not meet management's expectations, as net income was 42 percent below budgeted projections. The Report recognized marginal improvement in ROA, but also noted that much of this improvement was due to an accounting change relating to OREO holding costs that reduced expenses by \$243,000. Absent this change, the Bank's ROA would have been 0.31 percent instead of the reported 0.40 percent.

RMS addresses the recognition of revenue by explaining that the Bank is expected to comply with universal guidance applicable to all insured banks. RMS argues that six of the loans identified in the Bank's appeal were not adversely classified in the Report and did not affect the earnings analysis. RMS also contends that the Bank's policies and procedures for recognizing interest income on collateral-dependent loans remain a concern, as the Bank presumes a loan to be fully collectible, and thus recognizes interest income, whenever its impairment calculation does not result in a collateral shortfall.

RMS contends that the examiners did not penalize the Bank for its reliance on brokered deposits, but noted the negative effect of these higher-cost deposits on earnings. The increased interest expenses associated with these deposits significantly affected earnings and income because brokered deposits fund 47 percent of the Bank's total assets, while Federal Home Loan Bank borrowings fund 6 percent of total assets.

RMS argues that the Bank's earnings have been insufficient to support its high-risk business model and provide a satisfactory ROA to allow capital accretion while maintaining an appropriate allowance for loan and lease losses. Income has been hampered by the costs associated with non-performing loans and maintaining foreclosed real estate, valuation write-downs of OREO, and losses on sales of foreclosed properties. Earnings have been able to fund dividend payments to the Bank's holding company to cover interest payments on \* \* \* of Small Business Lending Fund ("SBLF") preferred stock and \* \* \* in subordinated debt, but holding company dividend payments remain suspended. Interest payments on the SBLF shares were scheduled to nearly double in August 2016, and the Bank's earnings are insufficient to redeem these shares while remaining well-capitalized for prompt corrective action purposes.

### ***The Committee's Findings***

UFIRS provides the following guidance on the Earnings component rating:

This rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.<sup>17</sup>

A "2" rating "indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above."<sup>18</sup>

A "3" rating "indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings."<sup>19</sup>

The record demonstrates that the examiners considered both revenue and expenses in their analysis, as the Report's discussion of earnings focuses on metrics that account for revenue, such as net income, ROA, and net interest margin. The examiners observed that elevated expenses relating to non-performing loans and foreclosed real estate negatively affected earnings, but this does not suggest that revenue was overlooked.<sup>20</sup>

The Bank's earnings do not appear to have been understated due to the examiners' judgment regarding recognition of interest income. The principles of revenue recognition at issue are part of the Call Report Instructions that apply to all insured banks. As explained above, adherence to such standards is necessary to ensure fair and effective bank supervision. Moreover, the dispute concerning revenue recognition only results in a delay, rather than a reduction, in the Bank's overall revenue. If loans are resolved favorably, as the Bank predicts, the associated revenue will be recognized in future Call Reports and examinations.

The Bank was not penalized for reliance on brokered deposits. The Report discusses the cost of brokered deposits in the context of earnings, but funding costs are an important part of a bank's

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<sup>17</sup> 62 Fed. Reg. 755.

<sup>18</sup> 62 Fed. Reg. 756.

<sup>19</sup> 62 Fed. Reg. 756.

<sup>20</sup> The Bank also contends that it provided the examiners with an analysis of the incremental revenue associated with its business model that was not addressed in the Report. *See* Exhibit #6. This analysis includes estimates for expenses and interest income at varying rates on a portfolio of loans, and appears to be a theoretical scenario intended to address the viability of the Bank's business model. The Report, however, is limited to discussion of the Bank's actual operating results and makes no judgments as to the viability of this business model.



cost structure. As the examiners noted, the Bank's comparatively high interest expenses reduced net income. The examiners also did not overlook the effects of deposit duration and overhead, as the Bank asserts; the earnings discussion states that a reduction in overhead expenses contributed to the Bank's improved ROA, and duration of deposits is addressed in the context of the Bank's strong rating for Sensitivity to Market Risk.

In the Committee's view, the Bank's earnings continue to require improvement. The Bank has demonstrated some progress, but its ROA remains below its peer group average and management's projections. A portion of the improvement in ROA can be traced to an accounting change, and the Report notes continued issues regarding compliance with regulatory guidance on revenue recognition, raising questions as to the quality of earnings. The trend of earnings is unclear, as interest expenses relating to the SBLF shares are increasing and the Bank incurred OREO losses in excess of budgeted amounts during the examination. The Bank's earnings have only allowed it to maintain relatively stable capital levels in an improving economic environment. Considering the Bank's inventory of foreclosed real estate, earnings could be substantially affected if economic conditions change. These concerns highlight the need for significant and sustained improvement in earnings, supporting the assigned "3" rating.

### ***C. Management Rating***

#### ***The Bank's Position***

The Bank argues that its Management component rating of "3" should be upgraded to "2." The Bank argues that the examiners' assessment of management relied on faulty conclusions relating to the Bank's asset quality and earnings. The Bank asserts that the examiners' criticisms have repeatedly been proven incorrect, and the Bank's long-term performance with respect to charge-offs and capital demonstrates that it is well-managed and operates with reasonable risk. The Bank contends that this performance, particularly through a deep recession, merits a "2" rating.

#### ***RMS's Position***

RMS argues that the "3" Management rating is appropriate, and the Bank has not demonstrated the sustained improvements in asset quality and earnings that would warrant an upgraded rating. High levels of non-performing loans and foreclosed real estate contribute to less than satisfactory asset quality and earnings performance. The Report recognized certain improvements, but also noted continued areas of legitimate supervisory concern. RMS also points out that additional efforts are required to fully comply with the provisions of the MOU. In particular, the Bank needs to define criteria that conform to regulatory guidance for determining when interest income may be recognized with respect to nonaccrual loans and develop more detailed strategies to achieve reductions in adversely classified loans, OREO, and nonaccrual loans.

#### ***The Committee's Findings***

UFIRS provides the following guidance on the Management component rating:

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable

laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.<sup>21</sup>

A "2" rating "indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled."<sup>22</sup>

A "3" rating "indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. . . . Problems and significant risks may be inadequately identified, measured, monitored, or controlled."<sup>23</sup>

As discussed more fully above, the Committee concludes that the Report describes legitimate weaknesses in the Bank's condition that management must address. Management also must make further efforts to fully comply with the provisions of the MOU. While the Bank has demonstrated some progress, management has not been able to achieve the significant and sustained improvements in asset quality and earnings necessary to operate the Bank in a safe and sound manner. Although management has maintained a relatively stable capital level, continued difficulties in managing credit risks raise concerns about the Bank's ability to withstand changes in economic conditions. The Committee concludes that the assigned "3" rating for Management is well-supported.

#### ***D. Composite Rating***

##### ***The Bank's Position***

The Bank argues that its Composite rating of "3" should be upgraded to "2" based on its long-term performance, evidenced by capital and earnings over ten years. The Bank explains that its history of charge-offs is superior to that of its peer group, and history has proven the examiners' judgment inaccurate with respect to revenue recognition. The Bank questions the basis for the conclusion, contained in RMS's response to its request for review, that its operations merit more than normal supervision. The Bank has expressed concern that it may never be able to achieve a Composite rating above "3" because of its chosen business plan.

##### ***RMS's Position***

RMS contends that during the relevant period, the Bank's asset quality and credit risk were less than satisfactory, and earnings did not adequately support the Bank's higher-risk business model.

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<sup>21</sup> 62 Fed. Reg. 754-55.

<sup>22</sup> 62 Fed. Reg. 755.

<sup>23</sup> 62 Fed. Reg. 755.

RMS asserts that adverse classifications, OREO, and delinquent loans continued to present regulatory concerns. RMS has argued that the Bank could attain a higher composite rating with its current business plan if it more fully addresses the risks in that plan.

RMS argues that its conclusion that the Bank's operations merit more than normal supervision was based on a broad analysis of the Bank's condition and performance, and was not based on its choice of business plan. RMS explains that the context surrounding that conclusion makes clear that the rating was based on less than satisfactory performance, including high levels of adversely classified items, OREO, and non-performing loans, in addition to elevated loan concentrations. These factors, rather than the Bank's choice of business plan, warrant the assigned Composite rating.

### ***The Committee's Findings***

The Statement of Policy on UFIRS notes that the Composite rating generally bears a close relationship to the component ratings assigned, but is not an average of the ratings, and that some factors may receive special emphasis.<sup>24</sup> Specifically, "some components may be given more weight than others depending on the situation at the institution . . . [and] the management component is given special consideration when assigning a composite rating."<sup>25</sup>

A rating of "2" is an indication that an institution is fundamentally sound. Under the FFIEC standards, an institution with a Composite rating of "2" presents only moderate weaknesses – weaknesses that are well within a board's and "management's capabilities and willingness to correct."<sup>26</sup> The rating is indicative of an institution that is both stable and capable of withstanding business fluctuations. Such an institution is in substantial compliance with all laws and regulations, and overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile, and there are no material supervisory concerns.

An institution with a rating of "3" indicates "some degree of supervisory concern in one or more of the component areas."<sup>27</sup> The combination of weaknesses may range from moderate to severe, though the magnitude of deficiencies is not as great as an institution with a Composite rating of "4." Management may be unable or unwilling to address weaknesses effectively and efficiently. A "3" rated institution requires increased supervision, which may include formal or informal enforcement action. Failure appears unlikely, given the overall strength and financial capacity of the institution.

The record of this case demonstrates that the Bank's asset quality and earnings were less than satisfactory during the relevant time period. The Committee also notes that additional action is required to fully comply with the MOU. The Committee does not believe that management must change the Bank's business plan to attain a higher Composite rating; instead, it must achieve the significant and sustained improvements that are necessary to operate the Bank in a safe and sound manner. The Committee affirms the Division Director's findings that the assigned

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<sup>24</sup> 62 Fed. Reg. 752.

<sup>25</sup> 62 Fed. Reg. 752-53.

<sup>26</sup> 62 Fed. Reg. 753.

<sup>27</sup> 62 Fed. Reg. 753.

component ratings accurately reflect the examination findings and that those findings support a Composite “3” rating.

## ***V. Conclusion***

For the reasons above, the Committee has upheld the determinations made by the Director of RMS with respect to the assigned ratings and has denied the Bank’s appeal.

The Committee believes that the improvements in the Bank’s performance recognized in the Report reflect management’s commitment to strengthening the Bank so that it can better serve its target market. Management also has expressed optimism that its efforts to expand and improve its infrastructure, as well as the future recognition of revenue that was delayed pursuant to the Call Report Instructions, will result in further improvements in operating performance. If the Bank is able to demonstrate the sustained improvements that it expects, the Committee is confident that future examinations will reflect those results.

This decision is considered a final supervisory decision by the FDIC.

By direction of the Supervision Appeals Review Committee of the FDIC, dated February 24th, 2017.