Decision of the

Supervision Appeals Review Committee

In the Matter of * * *

Case No. 2024-06

I. Summary

By letter dated August 21, 2024, * * * (Bank) submitted an appeal to the Supervision Appeals Review Committee (Committee) seeking the Committee's review of several ratings assigned by the FDIC at the Bank's October 16, 2023 safety and soundness examination. In the appeal, the Bank also sought the Committee's review of several apparent regulatory violations cited in the Report of Examination (ROE), as well as the FDIC's decision to initiate a Memorandum of Understanding (MOU) with the Bank to address the findings in the ROE. As described below, the Committee finds in favor of the FDIC Division of Risk Management and Supervision (RMS) with respect to all issues presented for review.

II. Background and Procedural History

The Bank is a Minority Depository Institution * * * that traditionally has focused on providing banking services and loans in and around * * *. In recent years, the Bank has expanded its lending program to include additional geographic locations in the State of * * *. A portion of these loans are originated through a third-party lending arrangement the Bank initiated in 2023 with * * *.

The FDIC's * * * Regional Office commenced a safety and soundness examination of the Bank on October 16, 2023. On April 9, 2024, the FDIC issued its ROE, assigning the Bank CAMELS ratings of 133223/3.[1] The ROE also cited apparent violations of Regulation O and certain * * * State Banking Rules, as well as nonconformance with Appendix A to Part 364 of the FDIC's regulations. The * * * Regional Office sought to initiate an MOU with the Bank to address the findings of the ROE. Concurrent with the safety and soundness examination, the * * * Regional Office conducted an Information Technology examination under the Uniform Rating System for Information Technology pursuant to which it assigned the Bank an IT Management component rating of "3".

On June 7, 2024, the Bank submitted a request for review to the FDIC's Director of RMS, appealing the FDIC's assigned Asset Quality, Management, Earnings, Liquidity, Sensitivity to

[1] Capital "1," Asset Quality "3," Management "3," Earnings "2," Liquidity "2," Sensitivity to Risk "3," and Composite "3."

Market Risk, and IT Management component ratings, as well as its Composite rating. The Bank also appealed the citations of apparent violations of Regulation O and certain * * * State Banking Rules, and the finding of nonconformance with the standards set forth in Appendix A to Part 364. Finally, the Bank appealed the Regional Office's decision to initiate an MOU.

On July 22, 2024, the Director of RMS granted the Bank's appeal as to the Asset Quality and IT Management component ratings but upheld the remaining determinations. On August 21, 2024, the Bank appealed to the Committee for review of its Management, Liquidity, Sensitivity to Market Risk, and Composite ratings; the citations of apparent violations of Regulation O and certain * * * State Banking Rules; the finding of nonconformance with Appendix A to Part 364; and the decision to initiate an MOU.

In accordance with the *Guidelines for Appeals of Material Supervisory Determinations* (Guidelines), the Committee has reviewed the appeal for consistency with the policies, practices, and mission of the FDIC, and the reasonableness and support for the positions of the parties. The Committee heard oral presentations from the parties on November 22, 2024, and subsequently met to consider the appeal.

III. Discussion

<u>Management Rating</u>

The Bank argues that the ROE's criticisms of the Bank's management practices were premised on misunderstandings regarding the roles and responsibilities of different officers that could have been corrected if the examiners had discussed them with Bank management prior to the issuance of the ROE. The Bank cites its recent financial performance as evidence of strong management practices and highlights its approach to succession planning and that its staffing strategy is sufficient to mitigate the resource gaps identified in the ROE. The Bank maintains that while its staff headcount has not increased commensurate with its loan and asset growth, this demonstrates improved efficiency rather than insufficient oversight. The Bank also objects to most of the risk management-related findings set forth in the ROE and asserts that the ROE mischaracterizes several of them as "repeat findings" from prior examinations.

RMS argues that a downgrade to a "3" Management Component rating is appropriate and consistent with forward-looking supervision, given the failure of the Board and management to adapt the Bank's risk management practices to the Bank's increasing volume of out-of-territory lending or its lending relationship with * * *, including credit administration weaknesses. RMS acknowledges the Bank's strong capital position and satisfactory financial metrics but maintains that the Bank failed to address repeat supervisory concerns from prior examinations. In addition, newly identified concerns could impact the Bank's financial condition, given the Bank's recent and projected growth. RMS asserts that inadequate staffing, which is identified as a repeat supervisory concern, is the root cause of most of the risk management-related concerns identified in the ROE.

Liquidity Rating

The Bank maintains that its liquidity levels and funds management practices warrant a Liquidity component rating of "1", particularly when evaluated against similarly situated peer institutions. Specifically, the Bank asserts that approximately * * * percent of its assets are "liquid" and that its large depositors are stable. In regard to the latter, the Bank monitors those relationships as part of its Asset Liability Committee (ALCO) review and weekly senior management meetings and takes objection with the examiners' finding that the Bank needed to obtain a "replacement" deposit to address the loss of a large depositor. The Bank believes its current funds management practices are adequate and the suggested enhancements in the ROE are already accomplished through the Bank's monitoring activities. The Bank also disagrees with the ROE's criticism that management overstated the Bank's liquidity position through inaccurate Call Report filings. The Bank argues that any misreporting of securities it pledged to the Federal Reserve's Bank Term Funding Program (BTFP) is irrelevant to its liquidity position because the Bank did not access credit under the BTFP, and therefore those securities remained unencumbered and a viable source of Bank liquidity.

RMS argues that the examination identified modest weaknesses in funds management practices relating to the Bank's large depositor monitoring, cash flow projections, internally calculated liquidity ratio, and liquidity related policies and procedures. RMS states that the examination findings are not consistent with well-developed funds management practices and preclude a "1" rating. RMS contends that a significant amount of the Bank's funding is from large depositors and the monitoring of such relationships is informal, and that the Bank should utilize stress tests to evaluate its liquidity position. RMS further argues that the Bank's loss of a large depositor suggests the relationship may have been less stable than the Bank believes, supporting the need for a formalized monitoring process. RMS maintains that the Bank misreported securities pledged to the BTFP, notwithstanding the fact that it did not borrow from the program.

Sensitivity to Market Risk Rating

The Bank argues that its exposure to interest rate risk remains low because its current funding and liquidity levels are sufficient to withstand potential interest rate shifts, thus warranting a higher component rating. In the Bank's view, the FDIC's Sensitivity to Market Risk rating of "3" was premised on recommended enhancements to its interest rate risk-management practices that could have been addressed through a collaborative and iterative process, rather than through a rating downgrade. The Bank disagrees with the characterization of certain weaknesses as "repeat findings". The Bank notes that it had responded to past examiner feedback by improving its Asset Liability Management (ALM) policy, its back-testing practices, and its interest rate risk modeling, as well as documenting discussion of these subjects in Board and ALCO meeting minutes.

RMS argues that the "3" rating was supported by a number of cited weaknesses and the Bank's failure to align its practices with its own policies. RMS asserts that the Bank's interest rate risk model showed exposure exceeding Board-approved policy limits in certain scenarios that were not addressed in the ALCO or Board minutes, as well as a lack of alignment between the Bank's ALM policy and limits in the interest rate risk reports. In addition, certain shock scenarios were not included in the ALCO or Board reports. RMS finds that these were repeat findings from previous examinations, including the Bank's repeated failure to align its back-testing practices with its ALM policy. RMS maintains that the Bank needs to improve its ability to monitor and control its interest rate risk exposure, provide more granular data in the interest rate risk model reports, review the scope and depth of the independent review, and improve training.

Regulation O Violation

Section 215.4(a)(1) of Regulation O requires extensions of credit to any insider of a bank to be made on substantially the same terms (including interest rates and collateral) and following credit underwriting procedures that are no less stringent than those prevailing at the time for comparable transactions by the bank with other persons not covered by Regulation O and who are not employed by the bank.[2] Regulation O also requires that the extension of credit not involve more than the normal risk of repayment or present other unfavorable features.

The Bank argues that it should not have been cited for an apparent violation of Regulation O for a commercial line of credit made to a Bank Director. The Bank maintains that the extension of credit was made on the same terms as would have been available to a non-insider. The Bank claims that RMS declined to review fifteen loans to non-insiders that had comparable terms. The Bank also disagrees with several findings in the ROE related to the management of this credit. In that vein, the Bank asserts that the Board properly approved the loan, that miscalculated payments were the result of a system error that affected several other loans, and that the line of credit was appropriately secured by collateral.

RMS contends that the line of credit to the Bank Director was an apparent violation of Regulation O because its terms were more favorable than a comparable line of credit offered to a non-insider of the Bank. The Bank produced only one comparison loan before the examination concluded, and the terms for that loan were less favorable than the line of credit provided to the Bank Director. RMS asserts that the record does not support the Bank's claim that the examination team declined to review additional, non-insider loans.

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[2] Section 22(h) of the Federal Reserve Act, 12 U.S.C. § 375b, imposes restrictions on extensions of credit to bank insiders, and the Federal Reserve Board adopted regulations implementing these restrictions at 12 C.F.R. Part 215. Section 18(j) of the Federal Deposit Insurance Act, 12 U.S.C. § 1828(j)(2), provides that these restrictions apply to insured nonmember banks, and the FDIC adopted regulations to implement these restrictions at 12 C.F.R. § 337.3.

Violation of [State] Banking Rules

[State] Rules and Regulations requires banks to [complete certain reconciliations for correspondent accounts]. The Bank argues that it was improperly cited for an apparent violation of this rule, as it began reconciling its Federal Reserve Bank correspondent account monthly following a previous examination. The Bank acknowledges that certain transactions remained unreconciled for periods longer than thirty days but maintains that it was continuing to research these transactions.

RMS argues that the Bank's reconcilement practices were neither timely nor effective, as demonstrated by the transactions that went sixty or ninety days without being properly reconciled. RMS notes that this was a repeat violation and that the Bank had a history of charging off unreconciled items from this correspondent account. RMS indicates that it consulted with staff at the [State], who confirmed that a citation would be appropriate under these circumstances.

Non-Conformance with Appendix A to Part 364

Appendix A to Part 364 of the FDIC's regulations sets out safety and soundness standards that the FDIC uses to identify and address problems at insured depository institutions before capital becomes impaired.[3] The ROE states the Bank is in non-conformance with the internal controls and information systems, loan documentation, credit underwriting, and interest rate exposure sections of the Operational and Managerial Standards of Appendix A to Part 364.[4]

The Bank argues that it should not have been cited for nonconformance with Appendix A to Part 364 of the FDIC's regulations. The Bank maintains that this citation was improper because its practices are more than adequate for a bank of its size and risk profile and because the shortcomings identified in the ROE could have been offered as recommendations. The Bank disagrees with the characterization of certain findings as repeat violations. RMS argues that the supervisory concerns identified in the ROE, spanning weaknesses in the Bank's internal controls and information systems, loan documentation, credit underwriting, and interest rate risk management, provide a basis for this citation.

Composite Rating

The Bank argues that a downgrade in its Composite rating to "3" is inappropriate because the Bank is fundamentally sound and stable, and examiners' findings can be addressed in the normal course of operations. The Bank notes that the objective measures of the Bank's financial health are strong. The Bank acknowledges opportunities for improvement in its risk-management practices but maintains they are appropriate for an institution of its size and risk profile. The

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[3] 12 CFR part 364, Appendix A.

[4] *Id.*, section II.

Bank further argues that certain findings by examiners were premised on factual inaccuracies or misunderstandings during the examination.

RMS acknowledges that the Bank's financial metrics are strong, but points to concerns regarding risk management practices from previous examinations, including several that are repeat findings. RMS argues that these repeat findings reflect negatively on Bank management's ability and willingness to address areas of concern, an important consideration in the Bank's rating. RMS insists that the Bank's risk management infrastructure has not kept pace with its growth, expansion into new lines of business, and increasing risk profile. RMS believes that the weaknesses identified in the ROE threaten the financial health of the Bank if not corrected, and that a Composite rating downgrade is consistent with its forward-looking approach to supervision.

Decision to Initiate an MOU

RMS sought to initiate an MOU with the Bank based on its "3" Composite rating and the weaknesses and repeat findings documented in the ROE. The Bank argues that initiating an MOU was punitive and unnecessary, and that the findings and apparent violations in the ROE could be addressed in the normal course of business through an ongoing dialogue with examination staff. RMS is of the view that initiating an MOU is appropriate under these circumstances and consistent with FDIC policy and practice.[5]

IV. Committee Findings

The Committee reviews an appeal "for consistency with the policies, practices, and mission of the FDIC and the overall reasonableness of, and the support offered for, the positions advanced."[6] The Committee's review is "limited to the facts and circumstances as they existed prior to, or at the time the material supervisory determination was made, even if later discovered, and no consideration will be given to any facts or circumstances that occur or corrective action taken after the determination was made."[7] The Committee has stated in the past that assigning supervisory ratings "inevitably involve a degree of subjectivity and judgment on the part of examiners."[8] Nevertheless, "[t]he burden of proof as to all matters at issue in the appeal . . . rests

[5] *See* FDIC Risk Management Manual of Examination Policies, at section 13.1-2 ("An MOU may be used to address specific problems at institutions rated 1 or 2 and should, at a minimum, be considered for all institutions rated 3. An MOU may not be required at an institution rated 3 if the regional director or designee determines that the institution's financial condition improved significantly or that there are other strong mitigating circumstances. For example, a weak management team may have been replaced by a strong management team, or an acceptable action by a state authority might make an MOU unnecessary. However, the mere belief that management recognized its errors and will improve the bank's condition is generally not a sufficient reason to make an exception").

[6] Guidelines § G(7).

[7] *Id*.

[8] In the Matter of ***, SARC Case No. 2024-02, at 3 (July 19, 2024).

with" the Bank.[9] A bank seeking the Committee's review of a rating must present sufficient evidence to demonstrate that the rating assigned was not appropriately supported by the record, or inconsistent with FDIC policy or practice.

<u>Management Rating</u>

Regarding the Management component rating, the Committee acknowledges the Bank's arguments regarding the level of due diligence provided to support the on-boarding and ongoing management of the third-party lending relationship with * * * as well as the credit performance of the loans originated under that lending program. The Committee also acknowledges that the Bank took certain corrective measures in response to prior criticisms regarding its out-of-territory lending. However, those measures do not appear to have fully addressed those supervisory concerns, which called for more specific and targeted updates to its lending policy. In addition, the ROE notes several instances in which Bank management acknowledged internal control deficiencies that required correction. While the Committee is sympathetic to the Bank's argument that staffing level by itself should not be viewed as a proxy for risk management, the Committee also recognizes RMS's concerns regarding the Bank's succession planning for certain key personnel and the need for the development of a more formal strategic staffing plan to support the Bank's growth trajectory. For these reasons, the Committee finds the Bank has not presented sufficient evidence to demonstrate that a Management component rating of "3" is not appropriately supported by the record or is otherwise inconsistent with FDIC policy.

<u>Liquidity Rating</u>

The Committee acknowledges the Bank's strong liquidity position, as well as its position that the securities that were pledged to, but remain unencumbered under, the Bank Term Funding Program are a viable source of liquidity for the Bank. The RMS Manual of Examination Policies (Manual) describes a Liquidity rating of 1 as indicating "strong liquidity levels and well-developed funds management practices." The Manual describes a 2 as indicating "satisfactory liquidity levels and funds management practices" and notes "modest weaknesses may be evident in funds management practices." Given the Bank's strong liquidity levels and the modest weaknesses RMS identified in the Bank's funds management practices, the Committee finds the Bank has not presented sufficient evidence to demonstrate that a Liquidity component rating of "2" is not appropriately supported by the record or is otherwise inconsistent with FDIC policy.

<u>Sensitivity to Market Risk Rating</u>

Under the Manual, a rating of "3" indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings or capital position will be adversely affected. RMS identified several instances where market risk management practices need improvement, and in addition the Committee notes that the interest rate risk simulation

[9] Guidelines § G(3).

demonstrated potential that earnings performance could be adversely affected under several rate scenarios. While the Committee acknowledges that the Bank appears to be taking measures to address supervisory findings from prior exams regarding its interest rate risk management practices, the Committee finds the Bank has not presented sufficient evidence to demonstrate that a Sensitivity to Market Risk component rating of “3” is not appropriately supported by the record or is otherwise inconsistent with FDIC policy.

Regulation O Violation

While the Bank argues the extension of credit to the Bank Director was made on the same terms as would have been available to a non-insider based on fifteen loans to non-insiders that had comparable terms, the Bank has not provided RMS or the Committee with those fifteen loans. Given the evidence available to the Committee, including the one comparison loan produced by the Bank, the Committee finds the Bank has not presented sufficient evidence to demonstrate that RMS’s citation of an apparent violation of Regulation O is not appropriately supported by the record or is otherwise inconsistent with FDIC policy.

Violation of [State] Banking Rules

The Committee finds the Bank has not presented sufficient evidence to demonstrate that RMS’s citation of an apparent violation of [State] Banking Rules is not appropriately supported by the record or is otherwise inconsistent with FDIC policy, particularly given that staff of the relevant State authority confirmed that a citation of the apparent violation of State law would be appropriate under the circumstances.

Non-conformance with Appendix A to Part 364

As previously noted, the Committee acknowledges the Bank’s arguments regarding the level of due diligence provided to support the on-boarding and ongoing management of the third-party lending relationship with * * *, as well as the credit performance of the loans originated under that lending program. Nonetheless, several findings in the ROE speak to internal control deficiencies and weaknesses in elements of the Bank’s risk-management program. Accordingly, the Committee finds the Bank has not presented sufficient evidence to demonstrate that RMS’s citation of non-conformance with Appendix A to part 364 is not appropriately supported by the record or is otherwise inconsistent with FDIC policy.

Composite Rating

Having found in favor of RMS with respect to all other issues presented in this appeal, the Committee finds the Bank has not presented sufficient evidence to demonstrate that a composite rating of “3” is not appropriately supported by the record or is otherwise inconsistent with FDIC policy.

Determination to Initiate an MOU

The RMS Manual of Examination Policies sets forth the circumstances when an MOU may be appropriate. Under the Manual, "an MOU may be used to address specific problems at institutions rated 1 or 2 and should, at a minimum, be considered for all institutions rated 3." The Manual further provides for certain considerations when determining whether to seek informal or formal action.[10] The Committee finds the Bank has not presented sufficient evidence to demonstrate that the decision to initiate an MOU is not appropriately supported by the record or is otherwise inconsistent with FDIC policy.

V. Conclusion

The Committee appreciates the efforts the Bank has made and fully supports MDIs, like the Bank, thriving and growing.[11] However, for the reasons stated above, the Committee finds in favor of RMS with respect to the Management, Liquidity, and Sensitivity to Market Risk component ratings, as well as composite rating. The Committee also finds in favor of RMS with respect to the citations of apparent violations of Regulation O and certain * * * State Banking Rules, the finding of nonconformance with Appendix A to Part 364 of the FDIC's regulations, and the determination to initiate an MOU with the Bank.

[10] RMS Manual of Examination Policies, at section 13.1.

[11] The Committee reminds the Bank of all technical resources the FDIC makes available to MDIs. Information regarding these resources is available at, Minority Depository Institutions Program: FDIC Technical Assistance Resources.