Audit Report

OIG-12-039

SAFETY AND SOUNDESS: Material Loss Review of Riverside National Bank of Florida

January 31, 2012

Office of Inspector General

DEPARTMENT OF THE TREASURY

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Abbreviations

CDO	collateralized debt obligation
CEO	chief executive officer
CFO	chief financial officer
FDIC	Federal Deposit Insurance Corporation
MRA	matter requiring attention

NRSRO	nationally recognized statistical rating organization
OCC	Office of the Comptroller of the Currency
ROE	report of examination
TruPS	trust preferred security

OIG

Audit Report

The Department of the Treasury
Office of Inspector General

January 31, 2012

John G. Walsh
Acting Comptroller of the Currency

This report presents the results of our material loss review of the failure of Riverside National Bank of Florida (Riverside), of Fort Pierce, Florida, and of the Office of the Comptroller of the Currency's (OCC) supervision of the institution. OCC closed Riverside and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on April 16, 2010. This review is mandated by section 38(k) of the Federal Deposit Insurance Act because of the magnitude of Riverside's estimated loss to the Deposit Insurance Fund (DIF).[1,2] As of December 31, 2011, FDIC estimated that the loss would be $240.9 million. FDIC also estimated that Riverside's failure resulted in a loss of $8.3 million to FDIC's Transaction Account Guarantee Program.

Our objectives were to determine the causes of Riverside's failure and associated impact to the DIF; assess OCC's supervision of Riverside, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish these objectives, we reviewed the supervisory files and interviewed officials at OCC and FDIC. We conducted our fieldwork primarily from June 2010 through October 2010. Appendix 1 contains a more detailed description of our review objectives, scope, and methodology. Appendix 2 contains background

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[1] At the time of Riverside's failure, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. Effective July 21, 2010, section 38(k) defines a loss as material if it exceeds $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar years 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met).
[2] Definitions of certain terms, which are underlined where first used in this report, are available in Treasury Office of Inspector General (OIG) *Safety and Soundness: Material Loss Review Glossary*, OIG-11-065 (Apr. 11, 2011). That document is available on the OIG's website at http://www.treasury.gov/about/organizational-structure/ig/Pages/by-date-2011.aspx.

information on Riverside's history and OCC's assessment fees and examination hours.

In brief, the primary cause of Riverside's failure was the bank's inability to manage its high-risk portfolios of (1) complex investments and (2) retail loans concentrated in an area where economic health was very much dependent on the strength of the local real estate industry. This resulted in significant losses on securities and loans and the ensuing erosion of earnings and capital significantly impaired Riverside's ability to sustain its business strategy. Regarding supervision, OCC should have taken enforcement action against Riverside after its 2007 examination of the bank. OCC's supervisory response in 2006 was too focused on the bank's financial performance rather than level of risk of its assets. OCC's guidance for investment securities has improved but does not quantitatively limit investments in mortgage-related securities. OCC's Special Supervision Division took appropriate enforcement action and PCA.

In other matters, we noted that Riverside's Tier 1 capital in its call reports consisted entirely or almost entirely of unrealized losses on available-for-sale debt securities during 2009 and 2010. This was because of the regulatory capital treatment of unrealized gains and losses on such securities.[3] We also noted that OCC examiners found it difficult to obtain from Riverside details on its transactions with affiliates and accurate information regarding possible insider trading by Riverside's CEO.

We recommend that the Comptroller of the Currency determine whether a limit, such as a specific percentage of capital, should be placed on the amount national banks can invest in complex mortgage-related securities before they must obtain OCC approval. We also recommend that OCC work with its regulatory partners to reevaluate the regulatory capital treatment of unrealized losses on available-for-sale debt securities in determining Tier 1 capital.

In a written response, which is included in appendix 3, OCC determined that a specific limit on complex mortgage-related securities is not necessary. While we accept OCC's determination, we believe OCC should periodically revisit the issue of setting specific limits if the

[3] Unrealized gains and losses result from fluctuations in fair value compared to the net carrying value of available-for-sale securities purchased by an entity with the intent and ability to hold such securities.

level of these securities in the national banking system rises in the future. OCC agreed to work with its regulatory partners to reconsider the way that unrealized gains and losses on available-for-sale debt securities are incorporated into the regulatory capital rules. We consider the planned action to be responsive to our recommendation. However, OCC will need to record the planned completion date for taking action in the Joint Audit Management Enterprise System (JAMES), the Department of the Treasury's audit recommendation tracking system.

Certain matters related to Riverside's operations are under review by the Treasury Inspector General's Office of Investigations and other agencies. We also provided the Treasury Inspector General's Office of Investigations with information obtained during our review related to other possible regulatory violations.

Causes of Riverside's Failure

Riverside grew rapidly, acquiring significant high-risk portfolios of complex investments and retail loans concentrated in an area where economic health was very much dependent on the strength of the local real estate industry.[4] However, it lacked effective policies and controls to manage the risks associated with these assets.

High-Risk, Complex Investments Concentrated in Real Estate

In 2005, Riverside began acquiring collateralized debt obligations (CDOs) linked to commercial real estate.[5] Riverside primarily accumulated a type of CDO backed by trust preferred securities (TruPS) which became popular when regulators began permitting banks to treat them as regulatory capital in 1996. In addition, Riverside purchased TruPS separately. From 2005 to 2007, Riverside purchased more than 20 CDOs backed by TruPS or other collateral and more than 30 TruPS. By March 2008, Riverside's portfolio of CDOs and TruPS amounted to more than $300 million, representing nearly 20 percent of the bank's total investment portfolio. The high volume of CDOs held by Riverside was unusual for a community bank.

[4] This growth was funded with higher-cost, wholesale funding sources including brokered deposits.
[5] A CDO is a type of mortgage-backed security that represents claims to cash flows from obligations such as mortgages, loans, and bonds. CDOs are thinly traded; therefore, their valuations typically come from modeling instead of actual trades.

In addition, Riverside's holdings of CDOs were so substantial that when the bank failed, the transfer of its investments to FDIC nearly doubled the value of FDIC's holdings of CDOs.

Riverside's investment policy was inadequate in regard to the initial evaluation and monitoring of the risk of the bank's complex investments. The policy required minimal evaluation of securities prior to purchase. Riverside relied almost entirely on the initial investment grade ratings[6] from nationally recognized statistical rating organizations (NRSRO)[7] to justify its purchase of securities. The policy also lacked triggers for reevaluating the quality of investments and did not define exit strategies. From 2006 through 2009, NRSROs downgraded Riverside's securities an average of 11 rating levels. As a result, Riverside's adversely classified investments, most of which were CDOs, increased dramatically, rising from $44 million—representing 13 percent of Tier 1 capital—in early 2008, to $168 million—representing 97 percent of Tier 1 capital—in early 2009, and to $597 million—representing 352 percent of Tier 1 capital—by early 2010.

In the end, the downgrades in Riverside's investment portfolio resulted in unsustainable losses for the bank. By 2008, nearly half of Riverside's total losses of $139 million consisted of losses on the bank's investments. In addition, Riverside's unrealized losses on securities exceeded $100 million in both 2008 and 2009. By the end of 2009, the value of Riverside's CDO portfolio had fallen by more than 60 percent, and the value of some of the CDOs had declined by more than 90 percent. Eventually, the bank was unable to sustain the combined effects of realized losses and erosion of capital.

Risky Lending Concentrations

Riverside's loan portfolio consisted of retail lending (consumer, home equity, and residential mortgage loans) and commercial/commercial real estate lending. Riverside's loan portfolio was dependent on the strength of the real estate market in its lending area and was significantly impacted by the market downturn.

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[6] 12 C.F.R. 1.2(d), *Investment Securities Definitions*, states that an investment-grade security is a security rated in one of the four highest credit rating categories of AAA, AA, A, and BBB.
[7] NRSROs include credit rating agencies such as Moody's Investors Service Inc. and Standard & Poor's, which issue credit ratings that may be used for certain regulatory purposes.

From 2005 through the bank's failure, retail loans represented at least 60 percent of Riverside's total loan portfolio and as much as 500 percent of its capital. The type and quality of the loans in Riverside's retail portfolio, particularly indirect automobile loans with subprime characteristics, contributed to the portfolio's riskiness.[8] In this regard, Riverside had concentrations of subprime automobile loans ranging from 25 percent to 32 percent of Tier 1 capital plus allowance for loan and lease losses from 2005 through 2008. These loans accounted for the bank's first loan losses, beginning in 2007. By 2010, Riverside's cumulative losses from indirect automobile loans exceeded $38 million, more than its losses from any other retail loan type.

The bank's commercial real estate loans were also directly affected when developers abandoned projects, jobs were lost and borrowers were unable to generate sufficient income to service their loans. By the end of 2009, Riverside sustained $170 million in direct loan losses (including $92 million for retail loans alone) and $235 million in provision expenses for impaired loans.

Riverside's Senior Management Had Broad Authority

According to OCC examiners, Riverside's chief executive officer (CEO) operated largely autonomous of other members of the bank's management team and the board of directors. He was able to commit the bank to transactions that exposed it to substantial losses and reputation risk. The CEO also hired senior personnel whom he trusted not to challenge his authority. The CEO gave Riverside's chief financial officer (CFO) sole authority for managing the bank's investment portfolio. Other members of the management team and the board relied heavily on the CFO to direct the bank's investment strategy. The CFO, however, had experience only in typical community banks that did not have extensive investment portfolios, and he had no experience managing complex investments such as CDOs.

Riverside's formal policies allowed the CFO to unilaterally direct the bank to buy and sell securities until the portfolio represented 40 percent of the bank's total assets. The bank's finance committee did reduce the limit to 35 percent in March 2007. However, in May 2007, the CFO requested the limit be increased back to 40 percent and the

[8] For indirect automobile loans, a car dealership acts as an intermediary between the bank and the purchaser.

finance committee approved the change. In addition, the CFO repeatedly and successfully pushed the board to either revise the bank's policies to allow for higher concentrations of riskier investments or grant waivers for policy violations when they occurred. For example, in May 2007, Riverside's policy was that securities rated BBB could not exceed 1.5 percent of total assets. When this limit was exceeded, the CFO simply requested a policy waiver which the finance committee granted.

Riverside's Board of Directors Failed to Maintain Effective Internal Control

In addition to the lax oversight of investment activities by its finance committee, Riverside's board did not act timely and appropriately to maintain an effective control environment within the bank. The board failed to address multiple internal control issues identified by the bank's internal auditors in 2007.[9] The board did not act until OCC formally documented these issues as matters requiring attention (MRA) [10] and legal violations in the 2009 report of examination (ROE).

For example, in 2006, OCC alerted Riverside's board of the need to develop procedures to better handle the recording of insider loans that were secured by stock of the bank's holding company. The board did not address OCC's concern. It continued approving such loans until 2008 and then reclassified the loans as commercial loans to circumvent the need for improved procedures.

Several board members and their families had taken loans from Riverside that were collateralized by the holding company's stock and serviced primarily by dividends from the stock. When Riverside began experiencing financial difficulty and the holding company's stock price fell, the bank charged off substantially all of the remaining loans to board members and their families, causing millions of dollars in losses to the bank.

[9] The internal control issues identified by the bank's internal auditors were (1) significantly aged items on the critical loan report (most over 120 days, and some over 360 days), (2) policy exceptions without required approval, (3) violations of the Truth in Lending Act, and (4) loan files missing required documentation or updated information.

[10] OCC uses MRAs to communicate to banks issues that deviate from sound banking principles, internal controls, or risk management. If not corrected, the issues outlined in an MRA could result in continuing financial deterioration.

OCC's Supervision of Riverside

OCC's supervision of Riverside did not prevent a loss to the DIF. In 2006, OCC was focused on the bank's positive financial performance instead of the existing and growing risk in its investment and loan portfolios. In this regard, we noted that OCC guidance was insufficient to identify the concentration risk represented by the significant volume of loans and investments that were dependent on the real estate industry. In addition, we found that OCC, according to its own guidance, should have issued an enforcement action after its 2007 examination of the bank.

The following table summarizes OCC's examinations of Riverside and related enforcement actions from 2005 to 2010. Generally, MRAs represent the most significant items reported in ROEs requiring corrective action.

Table 1. Summary of OCC's Riverside Examinations and Enforcement Actions

		Examination Results			
Date started/type of exam	Assets (billions)[a]	CAMELS rating	Number of MRAs	Number of recommendations or suggestions	Enforcement actions
4/18/2005 Full-scope examination	$2.4	2/122122	1	13	None
4/4/2006 Full-scope examination	$3.5	2/212212	0	13	None
4/16/2007 Full-scope examination	$4.4	2/222222	4	9	None
4/21/2008 Full-scope examination	$4.5	3/333322	4	2	Individual minimum capital ratio imposed Oct. 16, 2008 Formal agreement issued Oct. 28, 2008
10/[b]/2008 Targeted examination	$4.0	3/333332	0	0	None, formal agreement remained in effect
4/9/2009 Targeted examination	$3.6	4/444432	0	0	None, formal agreement remained in effect

Table 1. Summary of OCC's Riverside Examinations and Enforcement Actions

Date started/type of exam	Assets (billions)[a]	Examination Results: CAMELS rating	Number of MRAs	Number of recommendations or suggestions	Enforcement actions
4/13/2009[d] Full-scope examination	$3.6	5/555543	9	3	None, formal agreement remained in effect
9/14/2009[d] Targeted examination	$3.5	5/[c]	0	0	Consent order issued Nov. 10, 2009

Source: OCC supervisory documentation.
[a] Asset amounts are as of the immediately preceding quarter.
[b] Date was not specified in OCC's documentation.
[c] CAMELS component rating was not specified in OCC's documentation.
[d] Examination was directed by OCC's Special Supervision Division.

OCC's 2006 Examination Did Not Adequately Address Riverside's Existing and Growing Risk

OCC's supervisory response in 2006 was inadequate to address the existing and growing risk from Riverside's loans and investments. There were strong indicators of high risk that we believe should have been addressed as MRAs in 2006. Both Riverside's loan and investment portfolios were heavily tied to the real estate market. The retail loan portfolio included a large percentage of subprime loans with borrower repayment strongly dependent on the local real estate industry. The investment portfolio included large amounts of CDOs purchased in a short period of time. It was unusual for a community bank to be so heavily invested in CDOs. In addition, Riverside's CFO unilaterally directed the purchases that resulted in this large volume of complex securities. According to OCC examiners, stronger action was not taken because OCC relied on the positive financial performance of Riverside's loan and investment portfolios through 2006.

OCC did not use MRAs in 2006 to address its multiple findings on deficiencies in Riverside's loan portfolio management such as the risk associated with loans secured by Riverside stock. At March 31, 2006, Riverside had 172 loans with an outstanding balance of $24.1 million secured by Riverside stock with terms varying from 2 to 20 years. As previously mentioned, these loans were to Riverside board members and their families. In the 2006 ROE, OCC pointed out several risks with this type of loan. The risks included (1) the fact that Riverside

had no policies or procedures regarding this type of loan, (2) some of these loans were totally collateral dependent, and (3) the variance in the rates and terms of the loan. In addition, OCC did not address the risk associated with Riverside's borrowers' dependence on the local real estate industry.

With regard to Riverside's investment portfolio, OCC did not issue MRAs relating to the high risk of purchasing large amounts of highly complex securities including CDOs. OCC stated in the 2006 ROE that the investment portfolio totaled about $1 billion as of December 2005, which represented a nearly 90 percent increase from the previous examination. From January 2005 to December 2006, Riverside's investment portfolio doubled in size from roughly $752 million to over $1.5 billion. However, aside from noting the increase in size, OCC did not address the increased risk in the investment portfolio in 2006. The purchase of such a large volume of securities in such a short period of time under the direction of a CFO inexperienced with complex securities should have alerted OCC to the need for correction using an MRA.

OCC personnel told us that (1) OCC raised only minor issues with Riverside's retail loan portfolio in 2006 because the portfolio performed better than the retail loan portfolios of its peer banks; (2) OCC did not perform detailed analysis on highly-rated investments as the investments were performing well at the time; and (3) performance indicators showed that a booming real estate market still existed in 2006 and the bank's adversely classified assets were minimal. Nevertheless, we believe MRAs should have been used to address the overall riskiness of the loan and investment portfolios.

OCC Did Not Take Enforcement Action After Its 2007 Examination Identified Repeat Deficiencies

OCC should have issued an enforcement action after the full-scope examination in 2007. In the 2005, 2006, and 2007 ROEs, OCC repeatedly identified deficiencies with respect to inappropriate lines of reporting and loan portfolio management. OCC guidance states that a formal enforcement action is appropriate, regardless of a bank's capital level and composite CAMELS rating, when the bank fails to respond to prior supervisory efforts. The guidance also states that an enforcement action is normally appropriate if a bank's excessive

growth has not been accompanied by an appropriate control environment and management oversight.[11]

The number and nature of the deficiencies that OCC identified in the 2005, 2006, and 2007 ROEs indicated that the quality of Riverside's management and controls had clearly not kept pace with the growth in the bank's loan portfolio. OCC included one MRA, made 20 recommendations, and cited one legal violation related to deficient loan portfolio management in those ROEs. Although the bank corrected some of the deficiencies during this time period, other problems recurred, and OCC identified new deficiencies each year.

When we asked OCC officials about why they did not more forcefully address the issues with Riverside's loan portfolio, they said (1) historically, the bank had been successful in lending in its local market; (2) while OCC had given Riverside some comments regarding its lending over the years, it had not identified any extraordinary risks; and (3) unlike other banks in Florida which had concentrations in construction, land, and acquisition and development loans, Riverside's focus was on retail lending which was considered less risky. We believe, that in the case of Riverside, OCC misjudged the level of risk with the institution and the OCC guidance calling for enforcement action should have been followed.

OCC Guidance for Investment Securities Has Been Improved but Does Not Quantitatively Limit Mortgage-Related Securities

By regulation, OCC requires that banks conduct investment activities in a safe and sound manner. This regulation requires that banks consider interest rate, credit, and liquidity risk, among other factors.[12] In addition, OCC guidance alerts banks that purchasing long-term securities, like TruPS, from corporate issuers without appropriate controls over interest rate, credit, and liquidity risks, is an unsafe and

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[11] OCC, *An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution* (Jan. 2001).
[12] 12 C.F.R. Part 1, *Investment Securities*, §1.5, *Safe and sound banking practices; credit information required*.

unsound practice.[13] However, the above regulation and guidance do not limit holdings of commercial and residential mortgage-related securities to a percentage of total capital and/or specific amount. At the time Riverside was acquiring CDOs, the guidance directed banks only to exercise reasonable efforts to bring such investments into conformance in the event the ratings of such securities were downgraded below the highest investment grade rating categories.

In 2009, OCC issued supplemental guidance that directed bankers to avoid relying solely on the ratings of NRSROs in evaluating the quality of a bank's investments.[14] OCC examiners told us that additional tools to stratify risk and obtain data on securities have recently been made available to examiners; these resources were not available prior to 2008. They also commented to us that the current procedures for evaluating investments would have been helpful in examining Riverside's portfolio in 2005 and 2006. While we found the supplemental guidance more comprehensive than that previously available to OCC examiners, it is too soon to tell whether it will be effective in addressing the risks associated with investment concentrations.

It should be noted that the former Office of Thrift Supervision (OTS) did restrict thrift investments in complex securities. Specifically, it directed thrifts to limit aggregate investments in TruPS and securities with similar attributes to 15 percent of total capital. Thrifts that wanted to invest more than 15 percent of capital in such securities were required to obtain OTS approval.[15] We believe that establishing a restriction on national bank investments in complex mortgage-related securities like those purchased by Riverside should be considered by OCC.

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[13] OCC Bulletin 2002-19, *Revision to FDIC Rule 12 CFR 360* (June 17, 2009). ("National banks should demonstrate an understanding of the specific type of asset-backed security structures they plan to purchase. Investment policies should specifically permit the holdings and establish appropriate limits. National banks should conduct appropriate due diligence before purchasing complex asset-backed security structures and should consider the impact of such purchases on the bank's capital and earnings under a variety of possible scenarios.")
[14] OCC Bulletin 2009-15, *Investment Securities* (May 22, 2009).
[15] OTS Thrift Bulletin 73a, *Investing in Complex Securities* (Dec. 18, 2001).

Special Supervision Division's Use of Enforcement Action and Prompt Corrective Action Was Appropriate

OCC transferred supervision of Riverside to its Special Supervision Division, which directed overall supervision of the bank from April 2009, until the bank's closure in April 2010. The Special Supervision Division took the following actions:

- On May 7, 2009, in response to Riverside's call report for the period ended March 31, 2009, disclosing that the bank's total risk-based capital ratio had fallen to 7.87 percent, OCC notified Riverside that it was deemed undercapitalized for PCA purposes and directed Riverside to submit an acceptable capital restoration plan (CRP) by June 15, 2009. Riverside submitted a CRP on June 15, 2009. OCC disapproved the CRP, in part, because OCC was unable to determine that the CRP was realistic or likely to succeed in restoring Riverside's capital.

- On November 10, 2009, in response to Riverside's call report for the period ended September 30, 2009, disclosing that the bank's total risk-based capital ratio and leverage ratio had fallen to 4.45 percent and 2.44 percent, respectively, OCC notified Riverside that it was deemed significantly undercapitalized for PCA purposes, and that the bank was under a continuing obligation to submit a timely and completely revised CRP. Riverside also entered into a consent order with OCC that contained 21 articles, 19 of which required action by Riverside within specified time limits.

- Riverside's call report for the period ended December 31, 2009, disclosed that Riverside's capital ratios had improved slightly but Riverside remained significantly undercapitalized for PCA purposes.

- In a letter to OCC dated March 3, 2010, Riverside's legal counsel asserted that Riverside had a chance to survive or be sold without any loss to the DIF and pointed to improved earnings and capital ratios in the fourth quarter of 2009. In a response dated March 11, 2010, OCC noted that Riverside had not raised material capital, obtained a merger or acquisition partner, and that the improved earnings and capital ratios in the fourth quarter of 2009 were the result of a one-time tax benefit of $24 million. Additionally, OCC

noted that Riverside's earnings and capital ratios had declined in 2010.

- On April 16, 2010, OCC closed the bank and appointed the FDIC as receiver.

We concluded that the Special Supervision Division took appropriate actions under the circumstances to address Riverside's problems. We also concluded that OCC took appropriate enforcement action and properly implemented PCA after the transfer of supervision in April 2009.

Other Matters

We noted other matters during our review pertaining to the accounting treatment of unrealized gains and losses and Riverside's hindrance of OCC's examination process that we believe are necessary to report.

Regulatory Capital Treatment of Unrealized Losses on Available-for-Sale Debt Securities Should Be Reevaluated

Riverside's 2009 and 2010 call reports revealed that Riverside's Tier 1 capital consisted entirely or almost entirely of unrealized losses on its investments in securities. OCC personnel attributed this situation to a combination of the bank's complex securities and the regulatory capital treatment of unrealized losses on available-for-sale debt securities. In 2009 and 2010, Riverside's regulatory capital measures were substantially improved by the fact that unrealized losses on available-for-sale debt securities increased its regulatory capital. That is, though equity as determined under generally accepted accounting principles is formed by adding unrealized gains and subtracting unrealized losses, regulatory capital reverses those effects. Riverside reported a regulatory Tier 1 capital ratio as of March 31, 2009, of 5.73 percent. Removing the unrealized losses from the total Tier 1 capital on that date, we calculated that the Tier 1 capital ratio would have been 1.76 percent. OCC officials told us that through their regular supervisory assessment and monitoring of the bank's capital adequacy, they were aware of the makeup of Riverside's Tier 1 capital and that the size of unrealized losses was one of the reasons OCC moved to close the bank. An OCC official told us the bank would have

been substantially undercapitalized if the investment portfolio had been sold.

We believe that including unrealized gains and losses in the calculation of regulatory capital artificially portrays the level of Tier 1 capital and potentially creates an incorrect characterization of bank soundness. Accordingly, we believe that OCC should work with its regulatory partners to reevaluate the regulatory capital treatment of unrealized gains and losses on available-for-sale debt securities in determining Tier 1 capital.

Riverside Hindered OCC's Examination Process

OCC faced difficulty obtaining details on Riverside's transactions with affiliates. Specifically, the bank refused to provide such information, stating that it was confidential. OCC officials told us it was unclear whether the bank was refusing to provide information or actually lacked it as a result of poor management of records and management turnover. The bank's response forced OCC to take the additional step of requesting the information from the Board of Governors of the Federal Reserve System, the federal regulator of the bank's holding company. OCC subsequently found that Riverside had committed multiple violations of Regulation W, which governs transactions with affiliates, in 2006 and 2008.[16] OCC reported these violations in the 2009 ROE. OCC might have discovered these violations earlier if the bank had provided comprehensive, timely information on transactions with affiliates when first asked by OCC examiners.

We also reviewed OCC documentation that showed OCC had a difficult time in obtaining accurate information regarding possible insider trading by Riverside's CEO. An OCC examiner told us that there are fewer requirements for private companies such as Riverside to disclose stock valuation or stock price. The reduced transparency of stock activity impeded OCC's ability to assess whether insider trading had occurred when Riverside's CEO sold his stock in 2008 at potentially inflated prices. Again, OCC had to obtain the information they needed from the Board of Governors of the Federal Reserve System.

[16] 12 C.F.R. § 223, *Transations Between Member Banks and Their Affiliates*.

Recommendations

We have made a number of recommendations to OCC as a result of completed material loss reviews of failed banks during the current economic crisis. These recommendations include conducting a review of investments by national banks for any potential high-risk concentrations and taking appropriate supervisory action;[17] reviewing OCC processes to ensure that more timely enforcement action is taken once the need for such action is identified;[18] working with OCC's regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for bank investments;[19] and working with OCC's regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk, and determining an appropriate range of examiner response to high-risk concentrations.[20] Based on our review of the failure of Riverside, we reiterate the importance of these prior recommendations.

As a result of our material loss review of Riverside, we are making two new recommendations. Specifically, we recommend that the Comptroller of the Currency:

1. Determine whether a limit, such as a specific percentage of capital, should be placed on the amount national banks can invest in complex mortgage-related securities before supervisory approval must be obtained.

   Management Response

   OCC determined that a specific limit on complex mortgage-related securities is not necessary. OCC commented that it made this determination based on the existing safety and soundness rules and guidance on investment securities activities and the low level

[17] Treasury OIG *Safety and Soundness: Material Loss Review of National Bank of Commerce*, OIG-09-042 (Aug. 6, 2009).
[18] Treasury OIG *Safety and Soundness: Material Loss Review of Omni National Bank*, OIG-10-017 (Dec. 9, 2009).
[19] Treasury OIG *Safety and Soundness: Material Loss Review of Citizens National Bank*, OIG-10-038 (March 22, 2010).
[20] Treasury OIG *Safety and Soundness: Material Loss Review of Union Bank, National Association*, OIG-CA-10-009 (May 11, 2010).

of structured investment products currently in the national banking system.

OIG Comment

We accept OCC's determination that a specific limit on complex mortgage-related securities is not necessary. However, we believe OCC should periodically revisit the issue of setting specific limits on complex mortgage-related securities if the level of structured investment products in the national banking system rises in the future.

2. Work with OCC's regulatory partners to reevaluate the regulatory capital treatment of unrealized losses on available-for-sale debt securities in determining Tier 1 capital.

   Management Response

   OCC believes that reversing the effect of unrealized gains and losses on regulatory capital inappropriately alters the level of Tier 1 capital and potentially creates an incorrect characterization of bank soundness. Accordingly, OCC should work with its regulatory partners to reconsider the way that unrealized gains and losses on available-for-sale debt securities are incorporated into the regulatory capital rules. OCC commented that this is currently being considered for U.S. banks as an outgrowth of a December 2010 Basel Committee[21] paper, "Basel III: A global regulatory framework for more resilient banks and banking systems." That paper recommends bank supervisors worldwide require unrealized gains and losses to flow directly through to measures of regulatory capital.

[21] Auditor Note: The Basel Committee on Banking Supervision consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, Switzerland, where its permanent Secretariat is located.

OIG Comment

Management's proposed action is responsive to the OIG's recommendation. OCC will need to record its planned completion date for taking corrective action in JAMES.

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We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-0384. Major contributors to this report are listed in appendix 4.

Jeffrey Dye /s/
Audit Director

We conducted this material loss review of Riverside National Bank of Florida (Riverside), of Fort Pierce, Florida, in response to our mandate under section 38(k) of the Federal Deposit Insurance Act.[22] This section provides that if the Deposit Insurance Fund (DIF) incurs a material loss with respect to an insured depository institution, the inspector general for the appropriate federal banking agency is to prepare a report to the agency that

- ascertains why the institution's problems resulted in a material loss to the DIF;
- reviews the agency's supervision of the institution, including its implementation of the prompt corrective action provisions of section 38; and
- makes recommendations for preventing any such loss in the future.

At the time of Riverside's failure, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. We initiated a material loss review of Riverside based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of December 31, 2011, FDIC estimated that the loss to the DIF from Riverside's failure would be $240.9 million. FDIC also estimated that Riverside's failure resulted in a loss of $8.3 million to FDIC's Transaction Account Guarantee Program.

Our objectives were to determine the causes of Riverside's failure and associated impact to the DIF; assess the Office of the Comptroller of the Currency's (OCC) supervision of Riverside, including implementation of the prompt corrective action provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish our objectives, we conducted fieldwork at OCC's headquarters in Washington, DC, and OCC's field office in Miami, Florida. We also interviewed personnel from OCC's district office in Dallas, Texas; FDIC's Division of Resolutions and Receiverships at Riverside's former headquarters in Fort Pierce, Florida; and FDIC's Division of Supervision and

[22] 12 U.S.C. § 1831o(k).

Consumer Protection in both Broward County, Florida, and Atlanta, Georgia. We conducted our fieldwork primarily from June 2010 through October 2010.

To assess the adequacy of OCC's supervision of Riverside, we determined (1) when OCC first identified Riverside's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OCC took to get the bank to correct the problems. We also assessed whether OCC (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we performed the following work:

- We determined that the time period relating to OCC's supervision of Riverside covered by our audit would be from January 2005 through Riverside's failure on April 16, 2010. This period included five full-scope safety and soundness examinations and three targeted safety and soundness examinations. We analyzed examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OCC used to assess the bank's condition, and the regulatory action OCC used to compel bank management to address deficient conditions identified during examinations. We did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers other than those incidentally available through the supervisory files.

- We interviewed and discussed various aspects of Riverside's supervision with OCC officials, examiners, and an attorney to obtain their perspective on the bank's condition and the scope of the examinations.

- We interviewed FDIC officials responsible for monitoring Riverside for federal deposit insurance purposes.

- We reviewed reports of examination prepared by the Federal Reserve Bank of Atlanta for Riverside's holding company, to

gain an understanding of its assessment of the holding company's condition.

- We interviewed officials from FDIC's Division of Supervision and Consumer Protection who were involved in the supervision and closing of Riverside.

- We reviewed Riverside documents inventoried by FDIC upon closing the bank that were relevant to bank's failure and OCC's supervision of the institution.

- We assessed OCC's actions based on its internal guidance and requirements of the Federal Deposit Insurance Act.[23]

We conducted this performance audit 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.

[23] 12 U.S.C. § 1811 et seq.

History of Riverside National Bank

Riverside National Bank of Florida (Riverside) of Fort Pierce, Florida, was chartered as a commercial bank in 1982. The Office of the Comptroller of the Currency (OCC) was Riverside's primary regulator from the bank's inception. Riverside focused its operations in St. Lucie County, which is in a region of Florida known as the Treasure Coast. Riverside's main office was in Fort Pierce, and the bank had approximately 60 branches in 10 counties in Florida and held nearly 30 percent of all deposits in the Treasure Coast region. At its peak in 2007, Riverside employed over 1,000 employees and held more than $4.8 billion in assets. By March 2010, near the bank's failure date, Riverside's assets had declined to approximately $3.4 billion.

Riverside was a private company wholly owned by Riverside Banking Company, a one-bank holding company. The holding company was part of a chain banking structure, in which a small number of individuals controlled several independently chartered banks, each of which had its own holding company.

Before 2008, Riverside pursued an aggressive investment strategy uncommon to community banks, accumulating a substantial volume of high-risk, complex securities related to retail mortgages. By September 2008, Riverside's investments represented 29 percent of the bank's total assets, nearly double the size of the investment portfolios of Riverside's peer banks. In addition, the composition of Riverside's loan portfolio was unusual. Unlike many banks in Florida, Riverside was not highly concentrated in commercial real estate lending, but instead had an unusually large retail lending portfolio. Riverside focused on lending within the local market, which was primarily dependent on the real estate industry.

OCC Assessments Paid by Riverside

OCC funds its operations in part through semiannual assessments on national banks. OCC publishes annual fee schedules, which include general assessments to be paid by each institution based on the institution's total assets. If the institution is a problem bank (i.e., it has a CAMELS composite rating of 3, 4, or 5), OCC also applies a surcharge to the institution's assessment to cover

additional supervisory costs. These surcharges are calculated by multiplying the sum of the general assessment by 50 percent for 3-rated institutions or by 100 percent for 4- and 5-rated institutions. Table 1 shows the assessments that Riverside paid to OCC from 2005 through 2010.

Table 1: Assessments Paid by Riverside to OCC, 2005–2010

Billing Period	Exam Rating	Amount Paid	% of Total Collection
1/1/2005–6/30/2005	2	$212,220	0.07%
7/1/2005–12/31/2005	2	242,256	0.08%
1/1/2006–6/30/2006	2	282,497	0.09%
7/1/2006–12/31/2006	2	319,660	0.10%
1/1/2007–6/30/2007	2	371,250	0.11%
7/1/2007–12/31/2007	2	390,006	0.11%
1/1/2008–6/30/2008	3	380,576	0.11%
7/1/2008–12/31/2008	3	351,315	0.10%
1/1/2009–6/30/2009	4 & 5	495,185	0.13%
7/1/2009–12/31/2009	5	590,400	0.16%
1/1/2010–6/30/2010	5	588,466	0.15%

Source: OCC.

Number of OCC Staff Hours Spent Examining Riverside

Table 2 shows the number of OCC staff hours spent examining Riverside from 2005 to 2010.

Table 2: Number of OCC Hours Spent on Examining Riverside, 2005-2010

Examination Start Date	Number of Examination Hours
9/22/2005	2,461
9/15/2006	2,689
7/3/2007	4,272
9/2/2008	5,793
9/14/2009	1,566

Source: OCC Examiner View.
Note: Hours are totaled for safety and soundness examinations, information technology examinations, and compliance examinations and do not include time spent performing off-site monitoring.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Jeffrey Dye, Director, Banking Audits

From: John Walsh, Acting Comptroller of the Currency /s/

Date: January 12, 2012

Subject: Response to Material Loss Review of Riverside National Bank of Florida, Fort Pierce, Florida

We have received and reviewed your draft report titled "Material Loss Review of Riverside National Bank of Florida (Riverside), Fort Pierce, Florida." This review is mandated by section 38(k) of the Federal Deposit Insurance Act because of the magnitude of the bank's estimated loss to the Deposit Insurance Fund at the time of its failure. Your overall objectives were to determine the causes of the failure of Riverside; assess the OCC's supervision of the bank, including implementation of the Prompt Corrective Action (PCA) provisions of section 38(k); and make recommendations for preventing future losses. To accomplish these objectives, you reviewed the supervisory files and interviewed officials at OCC and FDIC.

You concluded that Riverside failed primarily due to its inability to manage its high-risk portfolios of complex investments and retail loans concentrated in the real estate industry. This resulted in significant losses on securities and loans. The ensuing erosion of earnings and capital significantly impaired Riverside's ability to sustain its business strategy. You concluded that the OCC should have acted more forcefully and sooner to address the unsafe and unsound practices with Riverside's concentration risk represented by the significant volume of loans and investments that were dependent on the real estate industry. You also determined that the OCC appropriately used its authority under PCA.

In addition to reaffirming four recommendations made in previous material loss reviews of OCC-regulated banks, you are making two new recommendations. Our response to each follows:

Determine whether a limit, such as a specific percentage of capital, should be placed on the amount national banks can invest in complex mortgage-backed securities before supervisory approval must be obtained.

OCC has determined that a specific limit on complex mortgage-related securities is not necessary. We made this determination based on the existing safety and soundness rules and guidance on investment securities activities and the low level of structured investment products currently in the national banking system. OCC has guidance on appropriate risk management of investment activities that dates back to 1998 with updates in both 2002 and 2009. In addition,

the OCC recently issued for comment new guidance to comply with Dodd-Frank requirements on credit rating reliance, and that guidance enhances and clarifies appropriate due diligence requirements for complex securities, to supplement external credit ratings.

Work with OCC's regulatory partners to reevaluate the accounting treatment of unrealized losses for securities for determining Tier I capital.

We believe that reversing the effect of unrealized gains and losses on regulatory capital inappropriately alters the level of Tier I capital and potentially creates an incorrect characterization of bank soundness. Accordingly, we believe that the OCC should work with its regulatory partners to reconsider the way that unrealized gains and losses on AFS debt securities are incorporated into the regulatory capital rules. This is currently being considered for U.S. banks as an outgrowth of the December 2010 Basel Committee paper, "Basel III: A global regulatory framework for more resilient banks and banking systems." That paper recommends that supervisors worldwide require unrealized gains and losses to flow directly through to measures of regulatory capital.

Thank you for the opportunity to review and comment on your draft report. If you have questions or need additional information, please contact Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, at 202-874-5020.

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Department of the Treasury

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Office of the Deputy Chief Financial Officer, Risk and Control Group

Office of the Comptroller of the Currency

Acting Comptroller of the Currency
Liaison Officer

Office of Management and Budget

OIG Budget Examiner

Federal Deposit Insurance Corporation

Acting Chairman
Inspector General

U.S. Senate

Chairman and Ranking Member,
Committee on Banking, Housing, and Urban Affairs

Chairman and Ranking Member,
Committee on Finance

U.S. House of Representatives

Chairman and Ranking Member,
Committee on Financial Services

U.S. Government Accountability Office

Comptroller General of the United States