Audit Report

OIG-12-043

SAFETY AND SOUNDNESS: Reviews of Failed National Banks Owned by First Bank of Oak Park Corporation

March 1, 2012

Office of Inspector General

DEPARTMENT OF THE TREASURY

Contents

Audit Report

Appendices

Abbreviations

Bank USA	Bank USA, National Association
California	California National Bank
Citizens	Citizens National Bank
CPP	Capital Purchase Program
CPP Council	TARP Capital Purchase Program Council
CRE	commercial real estate
CRP	Capital Restoration Plan

DIF	Deposit Insurance Fund
Fannie Mae	Federal National Mortgage Association
FBA	federal banking agency
FBOP	First Bank of Oak Park Corporation
FDIC	Federal Deposit Insurance Corporation
FRB	Board of Governors of the Federal Reserve System
Freddie Mac	Federal Home Loan Mortgage Corporation
GSE	Government Sponsored Enterprises
IMCR	Individual Minimum Capital Ratio
MRA	matters requiring attention
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
OTTI	other than temporary impairment charge
Pacific	Pacific National Bank
Park	Park National Bank
PCA	prompt corrective action
ROE	report of examination
San Diego	San Diego National Bank
TAGP	Transaction Account Guarantee Program
TARP	Troubled Asset Relief Program
Treasury	Department of the Treasury
WaMu	Washington Mutual Bank

March 1, 2012

John G. Walsh
Acting Comptroller of the Currency

This report presents the results of our reviews pursuant to section 38(k) of the Federal Deposit Insurance Act of the six failed national banks owned by the First Bank of Oak Park Corporation (FBOP). The Office of the Comptroller of the Currency (OCC) closed the banks and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on October 30, 2009. The table below shows the six banks, FDIC's estimated losses to the Deposit Insurance Fund (DIF)[1] and Transaction Account Guarantee Program (TAGP) as of December 31, 2011, and the type of review under section 38(k) we performed.

	Estimated Loss at December 31, 2011 (in millions)		
FBOP Bank Name and Location	**DIF**	**TAGP**	**Type of Review Performed**
California National Bank (California) Los Angeles, California	$900.1	$13.6	Material Loss
Park National Bank (Park) Chicago, Illinois	417.7	17.9	Material Loss
San Diego National Bank (San Diego) San Diego, California	366.7	12.6	Material Loss
Pacific National Bank (Pacific) San Francisco, California	310.9	2.3	Material Loss
Bank USA, National Association (Bank USA) Phoenix, Arizona	30.2	2.1	Limited
Citizens National Bank (Citizens) Teague, Texas	16.7	0.1	Limited
Total	**$2,042.3**	**$48.6**	

[1] Certain terms that are underlined when first used in this report, are defined in, *Safety and Soundness: Material Loss Review Glossary*, OIG-11-065 (April 11, 2011). That document is available on the Department of the Treasury (Treasury) Office of Inspector General (OIG) website at http://www.treasury.gov/about/organizational-structure/ig/Pages/by-date-2011.aspx.

Our material loss reviews of four FBOP national banks (California, Park, San Diego, and Pacific)[2] are mandated by section 38(k) because of the magnitude of each bank's estimated loss to the DIF at the time of failure.[3] The objectives of the material loss reviews were to determine the causes of the banks' failures and associated impact to the DIF; assess OCC's supervision of the banks, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such losses in the future.

In accordance with section 38(k), we also performed reviews of the other two FBOP national banks (Bank USA and Citizens) that were limited as the magnitude of these two banks' losses to the DIF was below the threshold requiring a material loss review. Our objectives for Bank USA and Citizens were limited to (1) ascertaining the grounds identified by OCC for appointing the FDIC as receiver and (2) determining whether any unusual circumstances exist that might warrant more in-depth reviews of the losses.

We conducted our fieldwork from March 2010 through August 2010. Appendix 1 contains a more detailed description of our objectives, scope, and methodology. Appendix 2 contains background information on the history of the six banks we reviewed and OCC's assessment fees and examination hours.

Results in Brief

The four FBOP banks that were the subject of our material loss reviews failed primarily due to significant losses associated with their concentrations in (1) investment securities, including government

[2] Throughout this report we collectively refer to these four national banks as the FBOP banks. FBOP also owned three state-chartered banks that were regulated by FDIC: North Houston Bank of Houston, Texas, Madisonville State Bank of Madisonville, Texas, and Community Bank of Lemont of Lemont, Illinois. FDIC OIG conducted a material loss review on North Houston Bank and Madisonville State Bank; and issued a separate report, which is available on their website at http://www.fdicoig.gov/reports10/10-036.pdf. FDIC OIG did not include the Community Bank of Lemont in its material loss review because, at the time of its failure, the institution's loss was not material as defined in the Federal Deposit Insurance Act.

[3] At the time of failure of the FBOP banks, 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).

sponsored enterprise (GSE) securities and corporate bonds, and (2) high-risk commercial real estate (CRE) loans. In addition, the FBOP banks did not maintain adequate capital levels to mitigate their increasing levels of risk, and were unsuccessful in efforts to obtain funds from either Treasury's Troubled Asset Relief Program (TARP) or private sources to make up for the losses sustained by the banks.

With respect to the failure of Park, FDIC issued the bank a Notice of Assessment of Liability that required an immediately payable cross-guaranty liability in the amount of $1.7 billion.[4] Though adequately capitalized prior to the Notice of Assessment of Liability, Park was no longer viable after the assessment since it exceeded the bank's total capital. The resulting depletion of Park's capital levels caused the bank to become critically undercapitalized with no reasonable prospect of recapitalization. As a result, OCC placed Park into receivership at the same time as the other FBOP banks.

Regarding supervision of the FBOP banks, we concluded that OCC had a reasonable basis at the time of its examinations for believing the banks could manage the risks of increased concentrations in CRE. We noted, however, that OCC permitted the FBOP banks to risk-weight the banks' GSE equity securities at 20 percent for regulatory capital purposes. The capital regulations of the other federal banking agencies (FBA) require risk-weighting these types of securities at 100 percent.[5] The effect is that OCC-regulated FBOP banks had to hold less regulatory capital as a cushion against losses.

OCC granted temporary relief to the FBOP banks on the capital treatment of deferred tax assets[6] that arose from the banks' GSE investment write-downs. We determined that OCC exercised reasonable supervisory judgment in providing this relief. As the FBOP

[4] FDIC also issued a Notice of Assessment of Liability to Citizens, one of the FBOP national banks for which we performed a limited review of the failure, rather than a material loss review.

[5] The other FBAs are the former Office of Thrift Supervision (OTS), FDIC, and Board of Governors of the Federal Reserve System (FRB). Effective July 21, 2011, pursuant to P.L. 111-203, the functions of OTS transferred to OCC, FDIC, and FRB, with OCC assuming the supervisory responsibility for federal savings associations.

[6] Deferred tax assets are assets that reflect, for reporting purposes, amounts that will be realized as reductions of future taxes or as future receivables from a taxing authority. Deferred tax assets may arise because of specific limitations requiring that certain net operating losses or tax credits be carried forward if they cannot be used to recover taxes previously paid. These "tax carry forwards" are realized only if the institution generates sufficient future taxable income during the carry forward period.

banks' reported falling capital levels immediately following the expiration of the deferred tax asset relief, we concluded that OCC used its authority under PCA in a timely manner.

Regarding our limited reviews of the Bank USA and Citizen failures, we determined that there were no unusual circumstances surrounding the banks' failures or the supervision exercised by OCC. Accordingly, we have determined that more in-depth reviews of these banks' failures by our office are not warranted.

We have referred certain capital-related transactions by Park and Citizens to the Treasury Inspector General's Office of Investigations.

Recommendation

We are recommending that OCC re-evaluate whether OCC requirements for risk-weighting of GSE equity securities should be changed from 20 percent to 100 percent.

Management Response

OCC also agreed that a re-evaluation of its guidance for risk-weighting GSE equity securities is appropriate, and anticipates addressing this in the upcoming notice of proposed rulemaking for Basel III[7] to ensure consistency among all of the federal banking agencies. We consider OCC's planned action to be responsive to our recommendation.

[7] The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision. The Committee's members come from 27 countries, including the United States. Basel III is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk agreed upon by the Committee in 2010-2011.

Causes of Failures of the FBOP Banks

Devaluations in Investment Securities

GSE Securities

Beginning in 2007, the FBOP banks purchased Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) preferred equity for investment purposes.[8] The combined book value of the GSE investments for all four banks was $802.5 million as of June 30, 2008, as shown in table 1 below. After the Federal Housing Finance Agency placed Fannie Mae and Freddie Mac into conservatorship on September 7, 2008, the combined market value of these investments declined significantly to $53.5 million, and the banks were required to write down their GSEs investments by approximately $749.0 million in total by September 30, 2008. The losses in market values of its holdings in these securities were one of the underlying causes of the FBOP banks' failures.

Table 1. FBOP Banks' Investments in GSEs and Write-Downs (in millions)

	Investments in GSEs		
FBOP Bank	**Book Value as of 6/30/2008**	**Market Value as of 9/30/2008**	**Total Write Downs as of 9/30/2008**
California	$434.8	$29.5	$405.3
San Diego	171.2	11.3	159.9
Park	112.2	7.3	104.9
Pacific	84.3	5.4	78.9
Total	**$802.5**	**$53.5**	**$749.0**

Source: OCC records of the FBOP banks' Fannie Mae and Freddie Mac data.

The devaluation of the Fannie Mae and Freddie Mac preferred stock contributed to significant losses and depletion of the banks' capital. For example, as of June 30, 2008, California reported $621.9 million in total risk-based capital and was well-capitalized for PCA purposes; and the bank's total risk-based capital ratio was 10.0 percent. Three

[8] Fannie Mae and Freddie Mac were created to provide stability in the secondary mortgage market and promote access to mortgage credit throughout the United States. By purchasing some mortgages and guaranteeing others, Fannie Mae and Freddie Mac help bring the liquidity of global capital markets to local banks and other financial institutions.

months later, as of September 30, 2008, California's total risk-based capital fell to $415.5 million; and the bank's total risk-based capital ratio fell to 6.5 percent, and the bank was undercapitalized. Subsequently, during the fourth quarter of 2008, the four banks were required to write down their GSEs by an additional $41.8 million in total.

Corporate Bonds

The FBOP banks began purchasing corporate bonds from some of the companies struggling in the financial, housing, and automobile sectors in 2007. These purchases included bonds issued by Washington Mutual Bank (WaMu). As shown in table 2, the FBOP banks wrote down their holdings of corporate bonds issued by WaMu by $99.0 million after WaMu failed in September 2008.[9]

Table 2. FBOP Banks' Write-Downs of WaMU Corporate Bond Holdings (in millions)

FBOP Bank	Total Write-downs as of 12/31/2008
California	$39.9
Park	29.6
San Diego	20.2
Pacific	9.3
Total	**$99.0**

Source: OCC records of the FBOP banks' other than temporary impairment charge (OTTI) data.

The devaluation of the WaMu bonds further contributed to significant losses and depletion of the FBOP banks' collective capital.

Concentrations in GSE Securities

For three FBOP banks (California, San Diego, and Pacific), their holdings in GSE securities represented concentrations of 64 percent, 54 percent, and 38 percent of total risk-based capital, respectively.

[9] We and the FDIC OIG performed a joint review of the causes of WaMu's failure and the federal supervision exercised over the institution. Our April 2010 report describes the high risk lending strategy by WaMu. (Treasury OIG and FDIC OIG, *Evaluation of Federal Regulatory Oversight of Washington Mutual Bank*, EVAL-10-002, April 9, 2010).

OCC defines a concentration as all holdings, by a single obligor or industry or related obligors or industries, equaling 25 percent or more of capital funds.[10] Concentrations pose additional risk to an institution because negative events affecting overly concentrated groups have greater detrimental impact. Statutory and regulatory standards, however, allowed banks to purchase investment securities issued by Fannie Mae and Freddie Mac without limitation.[11] In this regard, OCC's guidance states banks should exercise prudent judgment when purchasing these securities.[12] In an interview, OCC officials stated that FBOP management considered their 2007 decision to use nearly $1 billion in excess liquidity to purchase GSE preferred securities to be a safe investment based on these standards.[13]

In the end, however, the concentrations of the FBOP banks' holdings in GSE securities exposed the banks to greater risk and were contributing factors of their failures. In retrospect, as we have stated in a prior material loss review of an earlier failure of a national bank when the value of its GSE holdings collapsed, banks and regulators need to be cognizant that securities that are not backed by the full faith and credit of the U.S. government do entail risk, and high concentrations of such holdings elevate that risk.[14]

Aggressive Growth and High-Risk Concentrations in CRE Loans

The FBOP banks historically focused on CRE lending and, as a result, the banks' loan portfolios were concentrated in CRE loans. According to OCC's analysis of the failures of the FBOP banks, FBOP's business model included purchasing CRE loan pools at meaningful discounts to take advantage of market turmoil during economic slowdowns. Therefore, true to its business model, beginning in late 2007, as many other lenders were curtailing CRE lending activity, the FBOP banks' boards and management implemented a strategy of substantial loan growth by originating CRE loans and purchasing CRE-related loan pools. The banks' loan portfolio growth from the third quarter of 2007

[10] OCC Comptroller's Handbook, Section 216, Concentrations of Credits (March 1990).
[11] 12 U.S.C. 24 (Seventh); OCC Interpretive Letter #931 (April 2002).
[12] OCC Comptroller's Handbook, Section 203, Investment Securities (March 1990).
[13] The approximately $1 billion purchase of Fannie Mae and Freddie Mac preferred stock reflects the collective purchase amount for all nine FBOP banks.
[14] Treasury OIG, *Safety and Soundness: Material Loss Review of National Bank of Commerce,* OIG-09-042, (August 6, 2009).

to the third quarter of 2008 increased collectively, with growth in CREs averaging 34 percent.

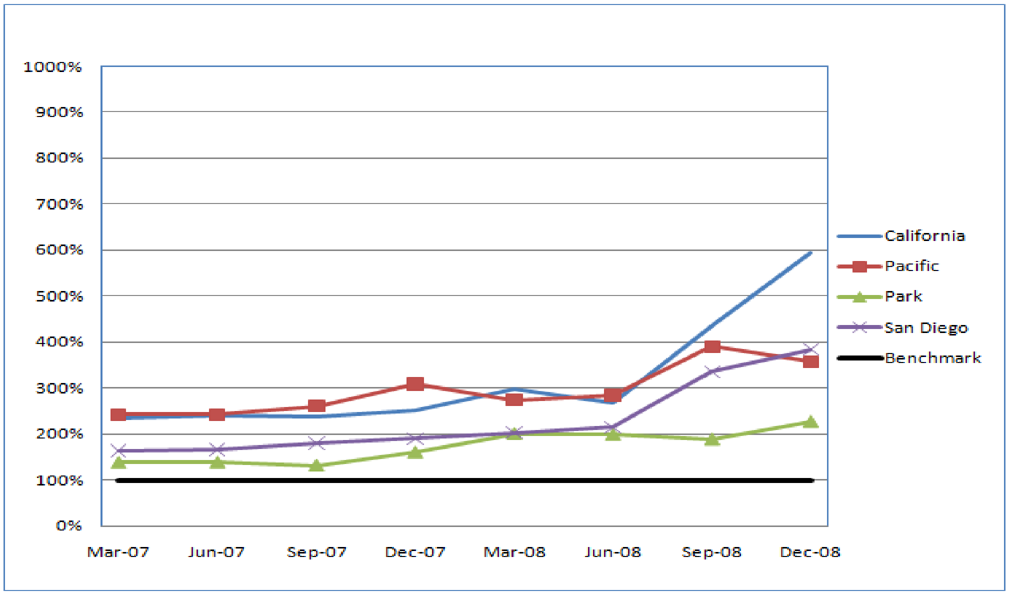
OCC guidance to examiners specifies the following levels at which an institution's CRE loans represent a concentration risk requiring further analysis:

- total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total risk-based capital; or
- total CRE loans represent 300 percent or more of the institution's total risk-based capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.[15]

As shown in figures 1 and 2, the FBOP banks' CRE loans as a percentage of total risk-based capital significantly exceeded supervisory benchmarks. It should be noted that the significant increase in the second half of 2008 can also be attributed to the lower capital levels as a result of the write-downs in the banks' holdings of GSE securities and corporate bonds.

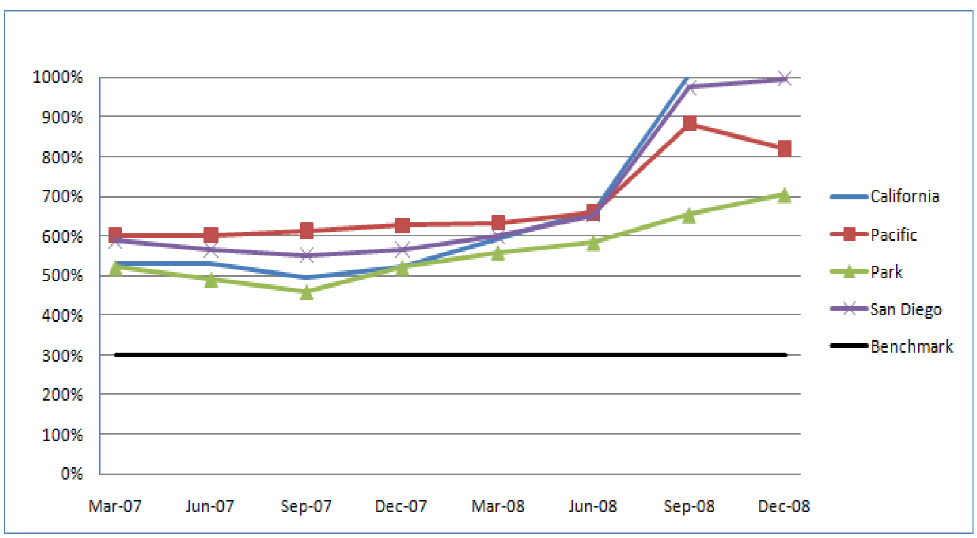
[15] OCC Bulletin 2006-46, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (December 6, 2006).

Figure 1: FBOP Banks' Construction, Land Development, and Other Land Loans As Percentages of Total Risk-Based Capital: March 2007 through December 2008



Source: FBOP banks' call reports as of March 31, 2007, through December 31, 2008.

Figure 2: FBOP Banks' Total CRE as Percentage of Total Risk-Based Capital: March 2007 through December 2008



Source: FBOP banks' call reports as of March 31, 2007, through December 31, 2008.

By late 2008 the FBOP banks' CRE loan portfolios began to deteriorate significantly. As of June 2009, CRE loans accounted for 98 percent of past due and non-accrual loans at California, 98 percent at Pacific, 81 percent at Park, and 98 percent at San Diego. As the deterioration in the FBOP banks' CRE loan portfolios and other investment losses depleted capital, the banks' CRE loans as a percentage of total risk-based capital dramatically increased in late 2008. Ultimately, exacerbated by the write-downs in the banks' holdings of GSE securities and corporate bonds, the FBOP banks were unable to recover from the increasing losses in their CRE loan portfolios.

Inadequate Capital Levels

The FBOP banks' capital levels were inadequate to support their significant exposure to loans with higher levels of credit risk. OCC regulations prescribe minimum capital ratios to be maintained by national banks.[16] These regulations also state that banking institutions should hold capital commensurate with the level and nature of all risks. OCC's Comptroller's Handbook cites risk diversification as a qualitative factor to consider when determining capital adequacy.[17] According to the Comptroller's Handbook, a greater degree of assets and liability concentrations increases the need for capital in most banks, and bank assets should be reviewed for concentrations in industries, product lines, customer types, funding sources, and nonbank activities.

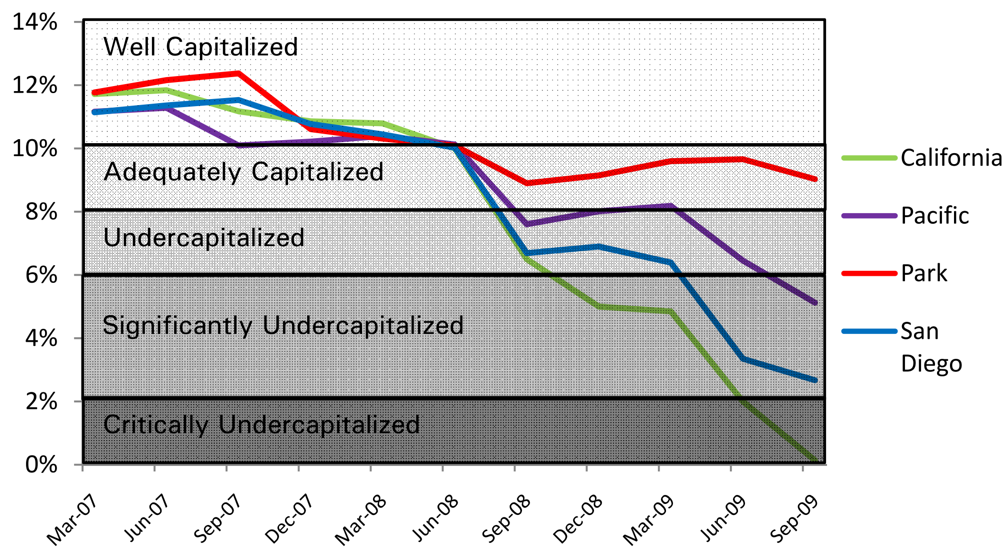
From the beginning of 2007, through the third quarter of that year, the FBOP banks' capital levels were above the PCA regulatory minimum capital level for well-capitalized, with Park more than 2 percent above the regulatory minimum as of September 2007. However, as illustrated by figure 3, beginning in the third quarter of 2007, two FBOP banks' capital levels declined as the banks increased their CRE loan concentrations and acquired GSE preferred equity investments. By the end of the first and second quarters of 2008, capital levels at each of the FBOP banks were either at or near the minimum levels to be considered well-capitalized under PCA. As a result, as discussed above, the FBOP banks did not have the capital necessary to withstand the adverse effects of the GSE write-downs and deteriorating CRE loan portfolios.

---

[16] 12 C.F.R. Part 3, Subpart B, §3.6, Minimum Capital Ratios, states that all national banks must have and maintain a minimum Tier 1 capital ratio of at least 3 percent of adjusted total assets. It further stated that all national banks must have and maintain the minimum risk-based capital ratio set forth in Appendix A, Risk-Based Capital Guidelines, which specifies 8 percent.

[17] OCC's Comptroller's Handbook, Section 303, Capital Accounts and Dividends (August 1991).

Figure 3. FBOP Banks' Risk-Based Capital Levels: March 2007 through September 2009



Source: FBOP banks' call reports as of March 31, 2007, through September 30, 2009.

By late 2008, FBOP estimated it needed $544 million in TARP funding and an additional $100 million in private capital for its banks to achieve well-capitalized status under PCA. However, the FBOP banks were not successful in obtaining TARP funding or additional capital from private sources. By the time OCC placed the FBOP banks into receivership in October 2009, each of the banks, with the exception of Park,[18] were either significantly undercapitalized or critically undercapitalized.

<u>Efforts to Obtain TARP Funding</u>

Treasury opened the TARP Capital Purchase Program (CPP)[19] to privately-held financial institutions like FBOP in November 2008. On December 2, 2008, FBOP submitted an application to OCC requesting a total of $544 million for all nine of its banks. Because the FBOP banks had composite <u>CAMELS</u> ratings of 3 and performance ratios that were below benchmarks established by Treasury, CPP program

[18] Park was considered adequately capitalized at the time of receivership.
[19] On October 14, 2008, Treasury announced the voluntary CPP under which Treasury could purchase senior preferred shares, on standardized terms, of publicly-held financial institutions. The program was extended to privately-held corporations on November 17, 2008.

procedures required that the application also be reviewed by the interagency TARP Capital Purchase Program Council (CPP Council).[20]

According to the minutes of the CPP Council meeting on December 17, 2008, OCC recommended making the TARP request contingent on FBOP raising additional private capital of $100 million. After discussion, the CPP Council agreed that further analysis and information was needed to address certain concerns and questions before the CPP Council could make a recommendation on the application.

On January 9, 2009, FBOP submitted an updated application to OCC. The minutes of the CPP Council meeting on January 14, 2009, indicated OCC recommended the TARP funding be approved but its recommendation was contingent on FBOP receiving and down streaming a $150 million bridge loan[21] into the banks. The minutes documented concerns and questions by CPP Council members regarding FBOP's condition and its recapitalization plan. According to the minutes, the CPP Council deferred action on the TARP application. An OCC official told us that FBOP's application for TARP funding was not presented again before the CPP Council; and ultimately, FBOP did not receive TARP funding.

Efforts to Raise Private Capital

Following the significant write-downs of the GSE investments, FBOP informed OCC that a $600 million transaction with a private equity group, consisting of $300 million preferred stock and $300 million subordinated debt, would close by September 30, 2008, or at the latest, in October 2008. The transaction however, never came to terms or agreement and the private equity group withdrew its interest when FBOP did not receive TARP funds. According to OCC officials, market trends at the time reflected investor interest was primarily focused on those institutions that were successful in obtaining TARP funds.

[20] The CPP Council consisted of representatives from OCC, OTS, FDIC, and FRB.
[21] FBOP's plan was to subsequently replace the bridge loan with subordinated debt.

Park's and Citizens' Cross-Guarantee Liability

An insured depository institution is liable for any loss incurred by FDIC, or any loss that FDIC reasonably anticipates incurring in connection with (1) the default of a commonly controlled insured depository institution or (2) any assistance provided by FDIC to any commonly controlled insured depository institution in danger of default.[22]

On October 30, 2009, OCC closed California, Pacific, San Diego, and Bank USA by appointing FDIC as receiver due to their critically deficient capital, asset quality, and earnings, and because there was no reasonable prospect for the institutions to become adequately capitalized without federal assistance. On the same day, FDIC, after consulting with OCC, issued a Notice of Assessment of Liability in the amount of $1.7 billion against Park, an FBOP-owned institution, which reported $391 million of total risk-based capital as of September 30, 2009.[23] FDIC also issued a separate Notice of Assessment of Liability of $118 million against Citizens, the other surviving FBOP-owned national bank. FDIC allocated the liability between the two institutions based on its estimate of the amount of the cross-guaranty liability shared between the two surviving FBOP institutions.

Park's immediately payable cross-guaranty liability caused the bank to not be a viable institution as the assessment exceeded Park's total capital. Park's depleted capital levels caused the bank to be critically undercapitalized with no reasonable prospect of becoming adequately capitalized. As a result, on October 30, 2009, OCC placed both Park and Citizens into receivership.

OCC's Supervision of the FBOP Banks

OCC's supervision of the FBOP banks did not prevent material losses to the DIF. We concluded that OCC had a reasonable basis at the time of its examinations to believe the banks could manage the risks of

[22] 12 U.S.C. §1815(e)(1)(A).
[23] FDIC issued a Notice of Assessment of Liability to Park and Citizens as each of the FBOP bank subsidiaries were insured depository institutions that FBOP commonly controlled. The liability amount reflected the anticipated proceeds of the transfer of certain assets of the closed banks to an acquiring institution in return for the assumption by the acquiring institution of certain deposits and liabilities of the closed banks.

increased concentrations in CRE. We noted that OCC is the only FBA to allow a 20 percent risk-weight of GSE equity securities; the other FBAs require a 100 percent risk-weight assignment for the same equity securities. We also determined that OCC exercised reasonable supervisory judgment in providing deferred tax asset relief to the FBOP banks. In addition, OCC used PCA in a timely manner.

Summary of OCC's Supervisory Actions

The following table summarizes OCC's examinations of the FBOP banks and related enforcement actions from 2006 to 2009.[24] Generally, matters requiring attention (MRAs) represent the most significant items reported in reports of examination (ROE) requiring corrective action.

Table 3. Summary of OCC's Examinations and Enforcement Actions for FBOP Banks

		Examination Results			
Date started/ completed[a]	**Assets (in (millions)**[b]	**CAMELS rating**	**Number of MRAs**	**Number of recommendations or suggestions**	**Enforcement actions**
California					
1/3/2006/ 4/13/2006	$5,512	1/221211	0	0	None
1/17/2007 7/12/2007	$5,584	1/221211	1	3	None
1/7/2008 4/25/2008	$5,633	2/221211	2	2	None
1/5/2009 4/21/2009	$6,292	4/544443	8	26	Individual Minimum Capital Ratios (IMCR) imposed 2/10/2009 Consent order issued 5/28/2009
Park					
10/16/2006 1/30/2007	$3,662	1/121112	0	0	None
8/29/2007 2/05/2008	$4,245	1/122121	2	7	None

[24] OCC followed its internal requirements with respect to the timeliness of annual examinations of the FBOP banks and quarterly monitoring of the bank.

Table 3. Summary of OCC's Examinations and Enforcement Actions for FBOP Banks

		Examination Results			
Date started/ completed [a]	Assets (in (millions) [b]	CAMELS rating	Number of MRAs	Number of recommendations or suggestions	Enforcement actions
9/22/2008 5/13/2009	$4,892	3/333332	11	25	IMCRs imposed 2/6/2009 Consent order issued 8/26/2009
San Diego					
6/12/2006 8/11/2006	$2,453	2/212112	1	7	None
6/11/2007 9/20/2007	$2,475	2/212212	0	0	None
5/27/2008 2/10/2009	$3,037	3/323432	6	13	IMCRs imposed 2/6/2009 Consent order issued 8/24/2009
Pacific					
8/1/2007 12/6/2007	$1,455	2/222312	0	0	None
7/25/2008 3/12/2009	$1,887	3/323432	7	16	IMCRs imposed 2/6/2009 Consent order issued 8/25/2009

Source: OCC ROEs and consent orders.
[a] An examination cycle concludes with the transmittal of the ROE.
[b] Asset amounts are as of December 31.

OCC Supervision of the FBOP Banks During a Critical Period of Growth in CREs and GSEs

Supervision of Aggressive Growth and Concentration in CREs

As discussed above, beginning in late 2007, the FBOP banks' boards and management implemented a strategy of substantial loan growth by originating CRE loans and purchasing CRE-related loan pools. This growth further increased the FBOP banks' CRE loans as a percentage of total risk-based capital, which had already significantly exceeded OCC supervisory benchmarks relating to CRE concentrations.

According to an OCC examiner, the CRE concentrations were not a supervisory concern in 2006 and 2007 and prior because the loans were well managed, well underwritten, geographically distributed, and diversified by property type. Furthermore, the OCC examiner stated FBOP's experience with CRE concentration and implementing this type of business model had been successful through different economic cycles. Another OCC examiner told us that FBOP had the system and processes in place to mitigate the concentration risks, as required by OCC's 2006 concentration policy.

In this regard, OCC's ROEs during 2007 did note strong management at the FBOP banks of CRE concentrations. For example, OCC's January 2007 ROE for California cited the bank's high CRE concentrations, but noted strong board and management oversight and the maintenance of strong credit practices despite competitive pressures. The ROE further noted that although California's risk was increasing due to concentrations in CRE loans and the recent weakening of the real estate markets, the examiners observed that management had prudently and actively managed this heightened risk level. In OCC's June 2007 ROE for San Diego, the examiners noted that within the CRE loan portfolio, there was reasonable diversification and that the board and management had demonstrated expertise and success in managing these concentration risks.

Though OCC overall did not have significant concerns with the CRE concentrations, they did note improvements were needed shortly after its 2006 concentration policy guidance was issued. For example, in their June 2007 ROE, the examiners recommended improvements to San Diego's loan underwriting and concentration risk management practices to conform to interagency guidance on CRE concentrations, including establishing formal concentration limits, an ongoing mechanism for reporting and reviewing concentrations, exception reporting for the board, and stress tests of the CRE portfolio.

Based on our assessment of the supervisory record, we concluded that OCC had a reasonable basis, at the time of its examinations, to believe the banks could manage the risks of increased concentrations in CRE.

Supervision of Capital Levels

As the FBOP banks pursued various growth strategies that increased the concentrations and credit risk at the banks in late 2007 and early 2008, capital levels at the banks declined, as shown in figure 3 above. By June 2008 the FBOP banks' capital levels declined to a point where they were barely above the regulatory minimum required to be considered well-capitalized.

OCC examiners cited in their 2007 ROEs for all four FBOP banks the threat of credit risk to capital due to large CRE concentrations. Subsequently, in their 2008 ROEs for the four banks, the examiners noted that the banks' loan growths had outpaced their capital growths. In the fourth quarter of 2008, in connection with OCC's ongoing monitoring of the banks' conditions, OCC noted that the four FBOP banks' risk profiles had significantly increased due to rapid loan growths, increased reliance on wholesale funding sources, declining loan quality, and substantial investment portfolio losses.

On December 12, 2008, OCC's examiners began reviews using financial data as of September 30, 2008. The subsequent review reports notified the FBOP banks of proposals to establish IMCRs requiring the banks to achieve and maintain the minimum total risk-based capital ratios of 10 percent, Tier 1 risk-based capital ratios of 8 percent, and minimum leverage ratios of 7 percent.[25] All the FBOP banks responded to the IMCR Notice stating that they agreed to the IMCRs or would make every effort to achieve them. In letters dated February 2009, OCC imposed the IMCRs requiring the banks to achieve and maintain the minimum total risk-based capital ratios by June 30, 2009. However by the time the IMCRs were issued in February 2009, the banks already experienced significant losses and California was deemed significantly undercapitalized, with San Diego being deemed undercapitalized.

As discussed above, OCC's capital regulations state that banking institutions should hold capital commensurate with the level and nature of all risks. According to the Comptroller's Handbook, higher levels of asset and liability concentrations increase the need for capital

[25] Prior to the IMCRs, the FBOP banks were required to meet PCA minimum capital ratios of 10 percent total risk-based capital, Tier 1 risk-based capital ratios of 6 percent, and minimum leverage ratios of 5 percent to be considered well-capitalized.

in most banks, and bank assets should be reviewed for concentrations in industries, product lines, customer types, funding sources, and nonbank activities.[26]

When we questioned the OCC examiners as to why the FBOP banks were not required in late 2007 and early 2008 to start holding more capital, the examiners cited the diversity in the types of CRE loans made by the FBOP banks and the banks' past successes with CRE lending during previous economic downturns as risk mitigation factors. As additional factors, OCC officials cited the banks' profitability, good asset quality, and manageable levels of problem assets through June 2008. When the FBOP banks' call reports for the first quarter 2008 were published on April 30, 2008, OCC noted the significant asset growth reported and began having discussions with management. As discussed above, due to the low capital levels relative to the risks they undertook, the FBOP banks did not have sufficient capital to weather the write-downs, in the third quarter of 2008, to the values of their GSE securities and corporate bonds, or the eventual asset quality deterioration in their CRE loan portfolios. However, we believe, based on the conditions at the time, OCC's supervisory approach of the banks' capital was overall understandable.

OCC Regulations for Risk-Weighting of GSE Securities Should Be Reconsidered

Bank assets are risk-weighted through assignment to one of four standard risk-weight categories, depending on the nature of the assets, obligors, and collateral.[27] As an asset's level of risk increases, the risk-weight assigned to the asset increases causing the total risk-based capital ratio to decrease. Therefore, higher volumes of riskier assets create the need for an institution to maintain larger amounts of capital.

As discussed above, the FBOP banks purchased significant quantities of GSE equity securities. OCC is the only FBA to risk weight these securities at 20 percent.[28] The capital regulations of the other FBAs require a risk-weight of 100 percent for the same equity securities. In this regard, the investments in Fannie Mae and Freddie Mac preferred

[26] OCC's Comptroller's Handbook, Section 303.
[27] There are four standard risk-weight categories: 0 percent, 20 percent, 50 percent, and 100 percent.
[28] 12 C.F.R. Part 3, Minimum Capital Ratios, Appendix A, Risk-Based Capital Guidelines, §3(a)(2)(vi).

equity made by the three FDIC-regulated FBOP banks were risk-weighted at 100 percent. OCC officials acknowledged the difference in risk-weight assignment among the FBAs. According to an OCC official, since there was a unique government relationship with Fannie Mae and Freddie Mac, the 20 percent risk-weight was adopted by OCC to reflect the quasi-governmental nature of the entities.

In light of the decline of market values and concentration of GSE securities also being reported in a prior material loss review,[29] we believe that OCC should re-assess its requirements on the risk-weighting of GSE equity securities. A higher risk-weighting serves to remind banks and examiners of the risks associated with certain bank asset classes. It also provides examiners with added rationale to recommend mitigating actions to banks when concentrations in certain industries and businesses approach levels that threaten the safety and soundness of an institution. While we recognize the unique government relationship with the GSEs, there was never a federal guarantee associated with the equity investments in these institutions. If the FBOP banks had been required to risk-weight their holdings in GSE equity securities at 100 percent, they may have exercised more caution in their decisions to invest in these types of equity securities.

OCC Provided Deferred Tax Asset Relief to the FBOP Banks

As of September 30, 2008, the FBOP banks recognized OTTI in the amounts of the write-downs of their holdings in GSE securities totaling $749 million. The FBOP banks reported a total of approximately $512 million of this amount as deferred tax assets on their balance sheets, and approximately $237 million was recorded as losses on their income statements.

OCC regulations on minimum capital ratios require that a bank deduct from its regulatory capital any deferred tax assets amounts that exceed the lesser of either:

- 10 percent of its Tier 1 capital, net of goodwill and all intangible assets other than purchased credit card relationships, mortgage servicing assets and non-mortgage servicing assets; or

[29] Treasury OIG, *Safety and Soundness: Material Loss Review of National Bank of Commerce,* OIG-09-042, (Aug. 6, 2009).

- The amount of deferred tax assets that the bank could reasonably expect to realize within 1 year of the quarter-end call report, based on its estimate of future taxable income for that year. [30]

FBOP calculated that, as of September 2008, 10 percent of Tier 1 capital for the FBOP banks, the lower of the two amounts, was approximately $102 million. Therefore, under the regulatory guidance, the FBOP banks would have been allowed to include $102 million in their regulatory capital. The remaining portion of the deferred tax assets ($410 million) would have been excluded from regulatory capital.

However, the regulatory guidance also allows OCC to waive the restrictions on deferred tax assets that banks can include in regulatory capital.[31] OCC exercised this discretion on November 5, 2008, when it granted temporary relief to the FBOP banks on the capital treatment of deferred tax assets. Rather than restricting the amount of deferred tax assets to be included in the FBOP banks' capital to $102 million, OCC allowed the FBOP banks to include as capital, deferred tax assets the banks expected to realize within 4 years. FBOP estimated this amount to be $343 million. This waiver was effective until the earlier of the banks' receipt of TARP funds or June 30, 2009.

According to OCC officials, OCC's justifications for providing the deferred tax asset relief included (1) sentiment expressed by Congress in the Emergency Economic Stabilization Act of 2008 (ESSA)[32] and by the announcements that the Secretary of the Treasury and FBAs would work with institutions adversely affected by the impairment of

[30] 12 C.F.R. Part 3, Minimum Capital Ratios, Appendix A, Risk-Based Capital Guidelines, §2,(c)(1)(iii).
[31] 12 C.F.R. Part 3, Minimum Capital Ratios, Subpart A, Authority and Definitions, §3.4.
[32] ESSA (P.L. 110-343) became law on October 3, 2008. Section 103(6) of ESSA states that the Secretary of the Treasury shall, among other things, take into consideration providing financial assistance to financial institutions with assets under $1 billion that were well or adequately capitalized as of June 30, 2008, and that as a result of the devaluation of the preferred GSE stock will drop one or more capital levels, in a manner sufficient to restore the financial institutions to at least an adequately capitalized level. While we do not disagree with OCC's view that there was sentiment by the Congress regarding the consideration of losses in preferred GSE stock in providing TARP financial assistance, the specific provision of EESA did limit that consideration to smaller banks.

GSE securities,[33] (2) the good earnings and the sound condition of the FBOP banks prior to the GSE-related impairment losses, and (3) the expectation by FBOP that its banks would generate sufficient taxable earnings to realize the deferred tax assets that exceed the regulatory capital limits.

Therefore, considering OCC's rationale for providing the deferred tax asset relief, its regulatory authority to provide the deferred tax asset relief, and the uncertainties at the time surrounding how regulators were to address the effects of the GSE receiverships to banks, we concluded that OCC exercised reasonable regulatory discretion in its decision to provide the deferred tax asset relief.

OCC's Use of PCA and Enforcement Actions

The purpose of PCA is to resolve the problems of insured depository institutions with the least possible long-term loss to the DIF. PCA requires FBAs to take certain actions when an institution's capital drops to certain levels. PCA also gives regulators flexibility to supervise institutions based on criteria other than capital to help reduce deposit insurance losses caused by unsafe and unsound practices.

As the FBOP banks' capital levels deteriorated, OCC imposed PCA restrictions in a timely manner and took other enforcement actions. Specifically, OCC took the following key actions:

<u>California and San Diego</u>

- On November 12, 2008, OCC notified California and San Diego that they were undercapitalized based on their September 30, 2008, call reports. California's and San Diego's total risk-based capital ratios were 6.5 percent and 6.7 percent, respectively.

[33] On September 7, 2008, concurrent with the action to place the GSEs into conservatorship, the FBAs jointly announced that they were prepared to work with institutions that had significant GSE holdings compared to their capital to develop <u>capital restoration plans</u> (CRP) pursuant to the capital regulations and PCA. In a release issued the same day, the Secretary of the Treasury stated that the FBAs were encouraging depository institutions to contact their primary federal regulator if they believe that losses on their holdings of GSE common or preferred shares, whether realized or unrealized, were likely to reduce their regulatory capital below "well capitalized." The Secretary noted that the FBAs were prepared to work with the affected institutions to develop CRPs consistent with the capital regulations.

OCC required the banks to submit acceptable CRPs by December 15, 2008.

- On December 15, 2008, California and San Diego submitted CRPs, which stated that FBOP would inject sufficient capital into the banks to increase their capital levels to well-capitalized. This capitalization was predicated on FBOP's issuance of $544 million in preferred shares pursuant to TARP or a $400 million private placement of FBOP's subordinated debentures and $300 million in borrowings from FDIC's Temporary Liquidity Guaranty Program.

- On February 6, 2009, and February 10, 2009, OCC imposed IMCRs on San Diego and California, respectively, to achieve by June 30, 2009, and maintain minimum total risk-based capital ratios of 10 percent, Tier 1 risk-based capital ratios of 8 percent, and leverage ratios of 7 percent. On these same dates, OCC informed the banks that the CRPs submitted on December 15, 2008, must include additional information and required the banks to submit revised CRPs and IMCR-related capital plans by February 28, 2009.

- On February 10, 2009, OCC notified California, that it was significantly undercapitalized based on its total risk-based capital of 5.36 percent reported on its December 31, 2008, call report.

- On February 27, 2009, California and San Diego submitted revised CRPs and IMCR-related capital plans. The revised CRPs included six options that FBOP was pursuing to raise capital, including (1) the consolidation of bank charters, (2) the sale of FBOP preferred stock or debt, (3) the sale of San Diego, (4) the sale of Park, (5) extending the maturity of outstanding debt, and (6) reapplying for TARP funding. The CRPs also provided that the banks would comply with IMCRs by not purchasing loans, loan participations or investments securities; and obtaining capital injections of $382 million and $145 million from FBOP for California and San Diego, respectively.

- On April 30, 2009, OCC disapproved the banks' revised CRPs and IMCR-related capital plans because they lacked sufficient support to indicate that the options would likely succeed in restoring the banks' capital and were unlikely to occur before June 30, 2009. OCC required the banks to submit revised CRPs by May 29, 2009.

- On May 28, 2009, California entered into a consent order with OCC. The consent order required the bank's board and management to address identified deficiencies in the bank's practices and condition. In particular, the consent order required California to a maintain total risk-based capital ratio of 10 percent, Tier 1 risk-based capital ratio of 8 percent, and leverage ratio of 7 percent. The consent order also required the bank to develop and submit to OCC a capital plan; maintain an adequate allowance for loan and lease losses; establish appropriate liquidity risk limits; revise its investment policy; establish loan concentration limits; and take immediate and continuing action to protect its interest in criticized assets.

- On May 29, 2009, California and San Diego submitted revised CRPs, which included restoring capital through the accumulation of earnings, a capital infusion, and minimal asset growth. The CRPs also included California receiving two capital infusions from FBOP during the second and third quarters of 2009, and San Diego receiving a capital infusion from FBOP during the second quarter of 2009.

- On July 6, 2009, OCC disapproved the California and San Diego revised CRPs, noting that the banks' efforts to raise capital were unsuccessful to date, and that FBOP's Chairman and Chief Executive Officer had stated that raising capital would take longer than originally planned. OCC directed California and San Diego to immediately prepare and submit revised CRPs.

- On July 31, 2009, OCC notified California and San Diego that they were critically undercapitalized based on the filing of their June 30, 2009, call reports. California's and San Diego's tangible equity ratios were 0.94 percent and 1.69 percent, respectively. OCC required California and San Diego to immediately submit acceptable CRPs.

- On August 24, 2009, San Diego entered into a consent order with OCC, including the same requirements as in California's consent order discussed above.

- On August 28, 2009, California and San Diego submitted revised CRPs and capital plans as required by the consent order. The CRPs provided that FBOP would raise at least $750 million from investors and inject sufficient capital into the banks to increase their capital levels to well-capitalized.

- On September 28, 2009, OCC notified California and San Diego that the CRPs were not acceptable because they relied on future events without sufficient detail. OCC was unable to conclude that the CRPs were realistic and likely to succeed in restoring the banks' capital levels. OCC directed the banks to submit disposition plans, pursuant to the consent order for the sale, merger, or liquidation of California and San Diego.

Pacific

- On November 12, 2008, OCC notified Pacific that it was undercapitalized based on the 7.6 percent total risk-based capital ratio reported on its September 30, 2008, call report. OCC required that the bank submit an acceptable CRP by December 15, 2008.

- On December 15, 2008, Pacific submitted a CRP, which stated that FBOP would inject sufficient capital into Pacific to increase the bank's capital level to well-capitalized. As discussed above, this capitalization was predicated on the receipt of TARP and FDIC Temporary Liquidity Guaranty Program assistance.

- On December 31, 2008, loan sales and a capital injection from FBOP in the fourth quarter of 2008 increased Pacific's total risk-based capital ratio to 8.01 percent. Pacific became adequately capitalized; therefore, eliminating the need to submit a CRP.

- On February 6, 2009, OCC imposed IMCRs on Pacific to achieve by June 30, 2009, and maintain, a minimum total risk-based capital ratio of 10 percent, Tier 1 risk-based capital ratio of 8 percent, and a minimum leverage ratio of 7 percent. OCC further directed Pacific to submit a 3-year, IMCR-related capital plan by February 28, 2009.

- On February 28, 2009, Pacific submitted an IMCR-related capital plan, which included six options that FBOP was pursuing to raise capital, including: (1) the consolidation of bank charters, (2) the sale of FBOP preferred stock or debt, (3) the sale of Pacific, (4) the sale of Park, (5) extending the maturity of outstanding debt, and (6) reapplying for TARP funding.

- On April 22, 2009, OCC disapproved Pacific's revised IMCR-related capital plan because it was based on actions that were not likely to succeed in restoring the bank's capital and were unlikely to occur before June 30, 2009. OCC required the bank submit a revised CRP by May 29, 2009.

- On May 27, 2009, Pacific submitted a revised IMCR-related capital plan, providing the bank's capital would be restored through a capital infusion of $51 million from FBOP in the second quarter of 2009.

- On July 7, 2009, OCC disapproved Pacific's revised IMCR-related capital plan, noting that the bank's efforts to raise capital were unsuccessful to date, and that FBOP's Chairman and CEO had stated that raising capital would take longer than originally planned. OCC directed Pacific to immediately prepare and submit a revised CRP.

- On July 31, 2009, OCC notified Pacific that it was undercapitalized based on the total risk-based capital ratio of 6.45 percent reported on its June 30, 2009, call report; and required that Pacific submit a CRP by August 28, 2009.

- On August 25, 2009, Pacific entered into a consent order with OCC, including the same requirements that were in California's consent order discussed above.

- On August 28, 2009, Pacific submitted a CRP and capital plan as required by the consent order. The CRP provided that FBOP would raise $750 million from investors and inject $70 million of new capital into Pacific to increase its capital level to well-capitalized.

- On September 28, 2009, OCC notified Pacific that the CRP was not acceptable because it relied on future events without sufficient detail. OCC was unable to conclude that the CRP was realistic or likely to succeed in restoring Pacific's capital level. OCC directed Pacific to submit a disposition plan, pursuant to the consent order for the sale, merger, or liquidation of Pacific.

OCC closed California, San Diego, and Pacific on October 30, 2009, and appointed FDIC receiver. The action was 91 days after California and San Diego were deemed critically undercapitalized.

Park

- On November 17, 2008, OCC notified Park that it was in the PCA adequately capitalized category based on the 8.9 percent total risk-based capital ratio reported on its September 30, 2008, call report.

- On February 6, 2009, OCC imposed IMCRs requiring Park to achieve IMCRs by June 30, 2009, and maintain a minimum total risk-based capital ratio of 10 percent, Tier 1 risk-based capital ratio of 8 percent, and a minimum leverage ratio of 7 percent.

- On February 26, 2009, Park submitted an IMCR-related capital plan, which included Park reducing net loans, selling investment securities, investing bank-owned life insurance in investments securities with a lower risk-weighting for capital purposes, and retain earnings. The plan did not rely on any capital injections from FBOP. OCC's 2008 ROE informed Park that its IMCR-related capital plan was acceptable.

- On August 26, 2009, Park entered into a consent order with OCC, including the same requirements as in California's consent order discussed above.

- On September 2, 2009, Park submitted a capital plan, as required by the consent order, which included FBOP raising at least $750 million from investors and injecting sufficient capital into Park to cause it to be well-capitalized.

- On September 28, 2009, OCC notified Park that the capital plan was not acceptable because it relied on future events without sufficient detail. OCC directed Park to submit a detailed plan, pursuant to the consent order, for the sale, merger, or liquidation of Park.

- On October 13, 2009, OCC notified Park that a $6.5 million capital contribution from FBOP on September 30, 2009, should not have been included in Park's regulatory capital. Park was required to reverse the contribution and exclude it from its regulatory capital levels in call reports filed after October 13, 2009.[34]

- On October 30, 2009, as a result of its $1.734 billion cross-guarantee liability to the FDIC in connection with its receiverships of the four closed national banks and three closed state banks, Park's capital was depleted to approximately negative $1.4 billion and the bank's tangible equity capital ratio was negative, approximately 30 percent. OCC notified Park that it was critically undercapitalized. OCC immediately placed Park in receivership with FDIC.

Causes of Failure of Bank USA and Citizens

Pursuant to section 38(k), we also conducted reviews of the failures of Bank USA and Citizens that were limited to (1) ascertaining the grounds identified by OCC for appointing the FDIC as receiver and

[34] On September 30, 2008, four FBOP banks, including Park and Citizens, made $40 million in loans to two non-bank subsidiaries. On the same date, the non-bank subsidiaries paid the $40 million as cash dividends to FBOP, which immediately infused the funds into five subsidiary institutions as capital. Park and Citizens received $6.5 million and $1.4 million, respectively, of the $40 million from FBOP. OCC determined based on Emerging Issues Task Force Issue No. 85-1, Classifying Notes Received for Capital Stock, that the banks received what was in substance a note, rather than an asset. Accordingly, the banks should have reported the note receivable from the non-bank subsidiaries as reductions of equity capital on their call reports. Therefore, OCC required both Park and Citizens to reverse the recording of the capital contribution as capital. We have referred these capital-related transactions to the Treasury Inspector General's Office of Investigations.

(2) determining whether any unusual circumstances exist that might warrant more in-depth reviews of the losses.

Bank USA

OCC appointed FDIC as receiver for Bank USA based on the following grounds: (1) the bank experienced substantial dissipation of assets or earnings due to an unsafe or unsound practice, (2) the bank incurred or was likely to incur losses that would deplete all or substantially all of its capital, and there was no reasonable prospect for the institution to become adequately capitalized without federal assistance, and (3) the bank's unsafe or unsound practices or condition are likely to otherwise seriously prejudice the interests of the bank's depositors or the DIF.

The primary causes of Bank USA's failure were a combination of credit losses, including substantial write-downs on investments in GSE securities, and the late 2007 decision by board and management to increase already significant concentrations in CRE lending. In 2008, the bank recorded write-downs of $12.6 million in its investment portfolio, with $10.9 million of this amount being attributable to its holdings in GSE securities. These losses significantly reduced Bank USA's capital, resulting in the bank not being able to weather the deterioration in its loan portfolio driven by a period of severe economic downturn in the CRE market. As the bank's financial condition further deteriorated, the bank was unable to raise adequate capital and OCC appointed FDIC as receiver on October 30, 2009.

Citizens

OCC appointed FDIC as receiver for Citizens based on the following grounds: (1) Citizens' assets were less than its obligations to its creditors and others, including members of the institution; (2) Citizens was undercapitalized and had no reasonable prospect of becoming adequately capitalized; and (3) Citizens was critically undercapitalized.

The primary cause of Citizens' failure was the immediately payable cross-guaranty liability of $118 million that Citizens owed FDIC in connection with its receiverships of the four closed national banks and three closed state banks. As a result of the cross-guaranty liability, which caused Citizens' total liabilities to exceed its total assets, Citizens became critically undercapitalized under PCA with no reasonable prospect of becoming adequately capitalized. On October 30, 2009, OCC closed Citizens and appointed FDIC as receiver.

We determined that there were no unusual circumstances surrounding the Bank USA's and Citizens' failures or the supervision exercised by OCC. Accordingly, we have determined that more in-depth reviews of these banks' failures by our office are not warranted.

Recommendation

As a result of our material loss reviews of the FBOP banks, we recommend that the Comptroller of the Currency re-evaluate whether OCC guidance for risk-weighting of GSE equity securities should be consistent with the other FBAs and changed from 20 percent to 100 percent.

Management Response

OCC agreed that a re-evaluation of its guidance for risk-weighting GSE equity securities is appropriate, and anticipates addressing this in the upcoming notice of proposed rulemaking for Basel III, to ensure consistency among all of the federal banking agencies.

OIG Comment

We consider OCC's planned action to be responsive to our recommendation. OCC will need to record in the Joint Audit Management Enterprise System (JAMES), the Department of the Treasury's audit recommendation tracking system, an anticipated date for completing its planned action.

* * * * *

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) 927-5776 or J. Mathai, Audit Manager, at (202) 927-0356. Major contributors to this report are listed in appendix 4.

/s/
Susan L. Barron
Audit Director

As one audit, we conducted material loss reviews of the following national bank subsidiaries owned by First Bank of Oak Park Corporation (FBOP) of Oak Park, Illinois, and collectively referred to in this report as the FBOP banks: (1) California National Bank (California) of Los Angeles, California; (2) Park National Bank (Park) of Chicago, Illinois; (3) San Diego National Bank (San Diego) of San Diego, California; and (4) Pacific National Bank (Pacific) of San Francisco, California. The material loss reviews were conducted in response to our mandate under section 38(k) of the Federal Deposit Insurance Act.[35] 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 (PCA) provisions of section 38; and
- makes recommendations for preventing any such loss in the future.

The law also requires the inspector general to complete the report within 6 months after it becomes apparent that a material loss has been incurred.

At the time of failure of the FBOP banks on October 30, 2009, 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 material loss reviews of the FBOP banks based on the loss estimates by the Federal Deposit Insurance Corporation (FDIC), which on the date of failure were $991.2 million, $695.5 million, $413.0 million, and $250.1 million for California, Park, San Diego, and Pacific, respectively.

Our objectives of the material loss reviews were to determine the causes of failure of the FBOP banks; assess the Office of the Comptroller of the Currency's (OCC) supervision of the FBOP banks, including implementation of the PCA provisions of

[35] 12 U.S.C. § 1831o(k).

section 38; and make recommendations for preventing such losses in the future. To accomplish our objectives, we conducted fieldwork at OCC's headquarters in Washington, DC, interviewed OCC and FDIC officials, and reviewed bank records that were located at FDIC's offices in Irvine, California. We conducted our fieldwork from March 2010 through August 2010.

To assess the adequacy of OCC's supervision of the FBOP banks, we performed the following work.

- We determined the time period relating to OCC's supervision of the FBOP banks covered by our audit would be from January 2006 through the banks' failures on October 30, 2009. This period included a total of 12 full scope safety and soundness examinations.

- We reviewed OCC's supervisory files and records for the FBOP banks from 2006 through 2009. We analyzed OCC's reports of examination, supporting supervisory documentation, and related supervisory correspondence to gain an understanding of the problems identified, the approach and methodology OCC used to assess the banks' conditions, and the regulatory action OCC used to compel bank management to address deficient conditions. We did not conduct independent or separate detailed reviews of the external auditors' work or associated workpapers other than those incidentally available through the supervisory files.

- We interviewed and discussed various aspects of the supervision of the FBOP banks with OCC officials and examiners to obtain their perspective on the banks' condition and the scope of the examinations.

- We interviewed FDIC officials responsible for monitoring the FBOP banks for federal deposit insurance purposes and in the closing of the FBOP banks.

- We interviewed an official with FDIC's Division of Resolutions and Receiverships who was responsible in the supervision and closing of the FBOP banks.

- We assessed OCC's actions based on its internal guidance and requirements of the Federal Deposit Insurance Act.[36]

- We viewed a hearing held on January 21, 2010, relating to federal regulators' roles and responsibilities in the supervision of banks.[37] As part of the hearing, OCC's Senior Deputy Comptroller for Midsize and Community Bank Supervision testified relating to, among other issues, the supervision of the national banks owned by FBOP. We also reviewed the OCC official's written testimony for the hearing.

With respect to FBOP's application for financial assistance from the Department of the Treasury's Troubled Assets Relief Program Capital Purchase Program, we reviewed FBOP's application and related materials in OCC's files and inquired of OCC personnel on their perspectives of the application. We also reviewed the minutes of the December 17, 2008 and January 14, 2009 Capital Purchase Program Council meetings when OCC presented and discussed FBOP's TARP applications. We did not, as part of our scope, review Treasury's processing of the application.

We also performed reviews of (1) Bank USA, National Association (Bank USA) of Phoenix, Arizona and (2) Citizens National Bank (Citizens) of Teague, Texas, FBOP's two other national bank subsidiaries whose estimated losses to the DIF did not meet the material loss review threshold as of the date of failure. As of December 31, 2011, FDIC estimated losses for Bank USA and Citizens were $32.2 million and $16.9 million, respectively.

Because the losses to the DIF were less than $200 million, as set forth by section 38(k) of the Federal Deposit Insurance Act, we conducted reviews of their failures that were limited to (1) ascertaining the grounds identified by OCC for appointing the FDIC as receiver and (2) determining whether any unusual circumstances exist that might warrant more in-depth reviews of the losses. Our limited reviews consisted of reviewing the

[36] 12 U.S.C. § 1811 et seq.
[37] The hearing was held by the House of Representatives Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit. The hearing was entitled "The Condition of Financial Institutions: Examining the Failure and Seizure of an American Bank."

supervisory memos and the reports of examination covering the period between 2006 through 2009 to determine the reasons for the failures of the banks and assess the supervision of the institutions by OCC. In addition, we inquired with OCC examination staff their views on the failures of these banks.

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.

History of FBOP's National Banks

First Bank of Oak Park Corporation (FBOP), a financial holding company headquartered in Oak Park, Illinois, wholly owned nine subsidiary institutions operating in Illinois, California, Texas, and Arizona. The Office of the Comptroller of Currency (OCC) was the primary federal regulator for the following six FBOP national banks: (1) California National Bank (California), (2) Park National Bank (Park), (3) San Diego National Bank (San Diego), (4) Pacific National Bank (Pacific), (5) Bank USA, National Association (Bank USA), and (6) Citizen's National Bank (Citizens). The Federal Deposit Insurance Corporation (FDIC) was the primary regulator for the following three state-chartered FBOP banks: North Houston Bank, Madisonville State Bank, and Community Bank of Lemont.

FBOP's six national banks had total assets of approximately $17.7 billion as of June 2009. Through these banks, FBOP had 147 branches serving Chicago, Los Angeles, Phoenix, San Diego, San Francisco, and Teague, Texas. FBOP also had <u>loan production offices</u> in Atlanta, Dallas, Denver, Minneapolis, New York City, Portland, Sacramento, and Salt Lake City. FBOP acquired a number of troubled institutions in Arizona, California, Illinois and Texas between 1990 and 2007. Those banks acquired in California and Illinois were consolidated into California and Park. In addition to each bank originating loans, they purchased participations in loan pools from Park. FBOP also provided services to the banks related to audit, compliance, information technology, investment advice, loan purchases, loan and <u>other real estate owned</u> services.

Although FBOP's six national banks were operated on a decentralized basis, FBOP's Chairman and Chief Executive Officer (CEO), who wholly owned FBOP, significantly controlled all major decisions. FBOP's Chairman and CEO also had a history of success in commercial real estate (CRE) lending, and FBOP's business model centered on CRE loan transactions. In late 2007, as many other lenders were curtailing their CRE lending activity, the FBOP banks implemented a growth strategy by originating CRE loans and purchasing loan pools primarily related to CRE. This strategy was consistent with FBOP's historical approach and represented FBOP's desire to take advantage of other institutions' unwillingness to finance CREs due the market conditions at the time. As of

June 30, 2009, real estate loans comprised approximately 93 percent of FBOP's national banks' total loan portfolios.

FBOP used wholesale funding sources such as the Federal Home Loan Bank and the Federal Reserve's Discount Window to implement its growth strategy.[38] In 2007, the FBOP banks also acquired significant amounts of Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) preferred equity for inclusion into their investment portfolio, as well as various corporate bonds.

The following is additional information relating to the six national banks owned by FBOP:

California

California was chartered in 1998; and was the largest of FBOP's six national banks with 68 banking locations in southern California, including its main office in Los Angeles. As of June 30, 2009, California reported total assets of $7.07 billion.

Park

Park was chartered as a state bank called Pullman Bank and Trust in 1883. Effective August 1995, the bank's primary regulator changed from the FDIC to the Board of Governors of the Federal Reserve System (FRB). The bank was acquired in 2003 by FBOP and converted to a national bank charter in January 2006. In January 2006, FBOP merged its five Chicago area institutions into Heritage/Pullman Bank and Trust Company and renamed it Park National Bank. Park's primary regulator changed from FRB to OCC. Park had 31 banking locations, including its main office, in the Chicago area. As of June 30, 2009, Park reported total assets of $4.8 billion. Park also had approximately $630 million in trust assets.

[38] A discount window is the lending facility of each regional Federal Reserve Bank through which depository institutions may borrow short-term to meet temporary liquidity needs and cover reserve deficiencies.

<u>San Diego</u>

San Diego was chartered in 1981. FBOP acquired San Diego in 1997, when its total assets were $229 million. San Diego had 28 banking locations, including its main office, in the San Diego area. As of June 30, 2009, San Diego reported total assets of $3.4 billion.

<u>Pacific</u>

Pacific opened as California Savings and Loan Association in 1887. Effective November 1, 2000, the bank changed its name to California Savings Bank. FBOP acquired California Savings Bank in 2004. In 2007, the bank's name changed to Pacific National Bank and converted to a national bank charter. Pacific had 17 banking locations, including its main office, in the San Francisco area. As of June 30, 2009, Pacific reported total assets of $2.1 billion.

<u>Bank USA</u>

Bank USA opened as Commercial Pacific Savings and Loan Association in 1984. FBOP acquired the institution in 2002. In 2007, the bank's name changed to Bank USA, National Association, and it was converted to a national bank charter. Bank USA had 2 banking locations, including its main office, in the Phoenix area. As of June 30, 2009, Bank USA reported total assets of $185 million.

<u>Citizens</u>

Citizens opened in 1984. Citizens had 2 banking locations, including its main office, in Teague, Texas. As of June 30, 2009, Citizens reported total assets of $105.5 million.

OCC Assessments Paid by the FBOP Banks

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. Tables 5 through 8 show the assessments paid to OCC by California, Park, San Diego, and Pacific from 2006 through 2009.

Table 5: Assessments Paid by California to OCC, 2006–2009

Billing Period	Exam Rating	Amount Paid	% of Total Collections
1/1/2006–6/30/2006	1	$439,454	0.15%
7/1/2006–12/31/2006	1	439,897	0.14%
1/1/2007–6/30/2007	1	458,785	0.14%
7/1/2007–12/31/2007	1	465,151	0.14%
1/1/2008–6/30/2008	2	439,471	0.12%
7/1/2008–12/31/2008	2	503,851	0.14%
1/1/2009–6/30/2009	4	492,271	0.13%
7/1/2009–12/31/2009	4	1,075,118	0.29%

Source: OCC $MART database.

Table 6: Assessments Paid by Park to OCC, 2006–2009

Billing Period	Exam Rating	Amount Paid	% of Total Collections
1/1/2006–6/30/2006	n/a*	n/a *	n/a *
7/1/2006–12/31/2006	1	$266,389	0.08%
1/1/2007–6/30/2007	1	280,599	0.08%
7/1/2007–12/31/2007	1	287,961	0.08%
1/1/2008–6/30/2008	1	302,313	0.08%
7/1/2008–12/31/2008	3	324,233	0.09%
1/1/2009–6/30/2009	3	348,132	0.09%
7/1/2009–12/31/2009	3	515,619	0.14%

Source: OCC $MART database.
*In January 2006, FBOP merged its five Chicago area institutions into /Pullman Bank and Trust and renamed it Park.

Table 7: Assessments Paid by San Diego to OCC, 2006–2009

Billing Period	Exam Rating	Amount Paid	% of Total Collections
1/1/2006–6/30/2006	2	$190,312	0.06%
7/1/2006–12/31/2006	2	190,880	0.06%
1/1/2007–6/30/2007	2	203,171	0.06%
7/1/2007–12/31/2007	2	199,978	0.06%
1/1/2008–6/30/2008	3	194,577	0.05%
7/1/2008–12/31/2008	3	223,043	0.06%
1/1/2009–6/30/2009	3	233,115	0.06%
7/1/2009–12/31/2009	3	383,054	0.10%

Source: OCC $MART database.

Table 8: Assessments Paid by Pacific to OCC, 2007–2009*

Billing Period	Exam Rating	Amount Paid	% of Total Collections
7/1/2007–12/31/2007	2	$126,508	0.04%
1/1/2008–6/30/2008	3	128,330	0.04%
7/1/2008–12/31/2008	3	160,409	0.04%
1/1/2009–6/30/2009	3	160,963	0.04%
7/1/2009–12/31/2009	3	265,512	0.07%

Source: OCC $MART database.
*Pacific converted from a thrift to a national bank charter in January 2007.

Number of OCC Staff Hours Spent Examining the FBOP Banks

Table 9 shows the number of OCC staff hours spent examining the FBOP banks from 2006 to 2009.

Table 9: Number of OCC Hours Spent on Examining the FBOP Banks, 2006-2009

FBOP National Bank	Examination Start Date	Number of Examination Hours
California	1/3/2006	2,310
California	1/17/2007	2,341
California	1/7/2008	3,056
California	1/5/2009	2,840
Park	10/16/2006	1,180
Park	8/29/2007	1,558
Park	9/22/2008	1,943

FBOP National Bank	Examination Start Date	Number of Examination Hours
San Diego	6/12/2006	1,537
San Diego	6/11/2007	1,112
San Diego	5/27/2008	1,875
Pacific*	8/1/2007	1,044
Pacific	7/25/2008	1,719

Source: OCC Examiner View.
*Pacific converted from a thrift to a national bank charter in January 2007.
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: Susan L. Barron, Audit Director

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

Date: February 3, 2012

Subject: Response to Reviews of Failed National Banks Owned by First Bank of Oak Park Corporation

We have received and reviewed your draft report covering the failures of six national banks owned by the First Bank of Oak Park Corporation (FBOP). Four of the failures caused material losses to the Deposit Insurance Fund – California National Bank, Park National Bank (Park), San Diego National Bank and Pacific National Bank – and two did not – Bank USA, National Association and Citizens National Bank (Citizens). The reviews are mandated by section 38(k) of the Federal Deposit Insurance Act. Your objectives for the material loss reviews were to determine the causes of the banks' failures; assess OCC's supervision of the banks, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such losses in the future. Your objectives for the non-material loss reviews were limited to ascertaining the grounds identified by OCC for appointing the FDIC as receiver and determining whether any unusual circumstances exist that might warrant more in-depth reviews of the losses. To accomplish these objectives, you interviewed OCC and FDIC officials, reviewed bank records, and reviewed OCC's supervisory files and records.

You concluded that the primary causes of failure of the FBOP banks were devaluations in investment securities, concentrations in government sponsored enterprise (GSE) securities, aggressive growth and high-risk concentrations in commercial real estate (CRE) loans, inadequate capital levels, and the cross-guarantee liability of Park and Citizens. You also concluded that the OCC had a reasonable basis at the time of its examinations to believe the banks could manage the risks of increased concentrations in CRE. You noted that OCC is the only federal banking agency to allow a 20 percent risk-weight of GSE equity securities; the other federal banking agencies (FBA) require a 100 percent risk-weight assignment for the same equity securities. You also concluded that the OCC exercised reasonable supervisory judgment in providing deferred tax asset relief to the FBOP banks and used PCA in a timely manner. We agree with these conclusions.

You are recommending that OCC re-evaluate whether our guidance for risk-weighting of GSE equity securities should be consistent with the other FBAs and changed from 20 percent to 100 percent.

We agree that a re-evaluation is appropriate, and anticipate that this will be addressed in the upcoming notice of proposed rulemaking for Basel III, assuring consistency among all of the federal banking agencies.

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

-2-

J. Mathai, Audit Manager
Sabrina A. Diggs, Auditor-in-Charge
K. Robert Hong, Auditor
Sheri A. George, Office Manager
Katherine E. Johnson, Referencer

Department of the Treasury

Deputy Secretary
Office of Strategic Planning and Performance Management
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

United States Senate

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

Chairman and Ranking Member
Committee on Finance

United States House of Representatives

Chairman and Ranking Member
Committee on Financial Services

Government Accountability Office

Comptroller General of the United States