Audit Report

OIG-18-034

FINANCIAL REGULATION AND OVERSIGHT

Material Loss Review of Guaranty Bank

December 29, 2017

Office of Inspector General

Department of the Treasury

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Abbreviations

CRP	capital restoration plan
DIF	Deposit Insurance Fund
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
Guaranty	Guaranty Bank
JAMES	Joint Audit Management Enterprise System
MRA	matter requiring attention
NSO	no supervisory objection
PCA	prompt corrective action
PCAD	prompt corrective action directive
PPM	Policies and Procedures Manual
OCC	Office of the Comptroller of the Currency

OIG	Office of Inspector General
OTS	Office of Thrift Supervision

December 29, 2017

Joseph M. Otting
Comptroller of the Currency

This report presents the results of our material loss review of the failure of Guaranty Bank (Guaranty) located in Milwaukee, Wisconsin and of the Office of the Comptroller of the Currency's (OCC) supervision of the institution. OCC closed Guaranty and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on May 5, 2017. Section 38(k)[1] of the Federal Deposit Insurance Act (FDIA)[2] mandated this review because of the magnitude of the bank's estimated loss to the Deposit Insurance Fund (DIF).[3,4] As of September 30, 2017, FDIC estimated that loss at $148.6 million.

The objectives of our audit were to (1) determine the causes of the bank's failure; (2) assess OCC's supervision of the bank, including implementation of the prompt corrective action (PCA) provisions of section 38; and, (3) make recommendations for preventing any such loss in the future. To accomplish these objectives, we reviewed OCC and FDIC supervisory files from 2011 through 2017, reviewed bank supervision guidance, and interviewed OCC officials involved in the regulatory enforcement matters. Appendix 1 contains a more detailed description of our objectives, scope, and methodology. Appendix 2 contains background information on Guaranty's supervisory history.

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[1] 12 U.S.C. § 1831o

[2] 12 U.S.C. § 1811 et seq.

[3] For losses incurred on or after January 1, 2014, Section 38(k) defines a loss as material if it exceeds $50 million (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met).

[4] 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 Office of Inspector General's (OIG) website at http://www.treasury.gov/about/organizational-structure/ig/Pages/by-date-2011.aspx.

In brief, we found Guaranty failed primarily because of relaxed loan underwriting standards, poor risk management, and deficient supervision by the board of directors and bank management.

Regarding supervision, OCC examiners generally followed guidance in supervising Guaranty; however, that supervision did not prevent a material loss to the DIF. We found that OCC did not adequately review (1) Guaranty's request for retention bonuses for PCA compliance prior to providing a determination of no supervisory objection (NSO); [5] and, (2) the salaries of Guaranty's senior executives and therefore did not detect until 2017 that Guaranty gave yearly salary increases to senior executive officers which were prohibited by PCA. As a result, the bank paid $468,926 in bonuses and salary increases to senior executive officers in violation of PCA.

As a result of our audit, we plan to refer the matter of Guaranty's violations of PCA to the Treasury Inspector General's Office of Investigations.

We are recommending that the Comptroller of the Currency develop and document examination procedures, for banks subject to PCA restrictions, that are designed to identify and track all types of compensation paid to executive officers as defined in 12 CFR 215 *Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks,* also known as Regulation O[6]. The implementation of documented examination procedures for identifying and tracking executive officer compensation (salary, bonuses, etc.) will enhance compliance monitoring of compensation restrictions.

In a written response, which is included as appendix 3, management stated it concurred with the findings and recommended corrective action. OCC will continue to follow its longstanding practice of notifying banks of their responsibility to adhere to the restrictions applicable to them based on their PCA capital category, including restrictions on compensation. Also, OCC commits to developing internal procedures that create standards for problem bank specialists

[5] OCC uses the term "no supervisory objection" to convey that they do not find a compelling supervisory or regulatory reason to deny the request. OCC does not consider an NSO an "approval".

[6] Regulation O is a regulation set forth by the Board of Governors of the Federal Reserve System and it governs any extension of credit by a member bank to an executive officer, director, or principal shareholder of that bank, of a company of which the member bank is a subsidiary, and of any other subsidiary of that holding company.

to monitor all types of compensation paid to executive officers for compliance with appropriate PCA restrictions. OCC will finalize the new standards and provide training to problem bank specialists by January 31, 2018. Further, OCC is updating its internal *Examiners' Guide to Problem Bank Supervision* and will expand the *Examiners' Guide* to include a more comprehensive section on compliance with PCA restrictions. OCC plans to finalize and internally publish the *Examiners' Guide* to all OCC employees by September 30, 2018.

We consider OCC's planned actions responsive to our recommendation. We have summarized the response in the recommendation section of this report. Management will need to record the estimated date for completing its planned corrective action in the Joint Audit Management Enterprise System (JAMES), Treasury's audit recommendation tracking system.

Causes of Guaranty Bank's Failure

Relaxed Loan Underwriting Standards

From 2005 to 2007, Guaranty's board of directors and management adopted a more aggressive business model for lending than previously followed. The bank began to offer "alternative" first mortgages, also known as "Alt-A" loans, that were considered prime quality but had some unique features, such as being interest-only. Alt-A loans are typically low to no documentation loans that are based on the borrower's stated income, assets, and expenses. These Alt-A loans accounted for the majority of Guaranty's first mortgage loan production during these years, and ultimately became a source of its credit losses. The bank also increased the volume of home equity loans, including "stated income" loans that did not require borrowers to prove their income. The poor performance of the home equity loan portfolio was the primary driver of the bank's significant, continuous operating losses and deteriorated capital levels.

Although Guaranty ceased lending under these programs in 2008 and essentially ceased mortgage originations with the sale of its principal mortgage subsidiary in 2013, these relaxed underwriting standards resulted in a high concentration of poor quality home equity loans from which the bank never recovered.

Poor Risk Management

Guaranty's board of directors and management failed to implement an adequate risk management framework and failed to maintain an adequate level of capital protection for its lines of business. Instead, Guaranty's risk management strategy was to purchase credit loss insurance[7] for its home equity loans, which left the bank significantly dependent upon the insurance carriers' solvency and willingness to pay claims. Consequently, when the real estate market collapsed and the economy went into recession, Guaranty experienced significant asset quality problems as much of its home equity portfolio was under-collateralized. As the real estate crisis deepened, mortgage insurers became increasingly unwilling to pay claims, causing the bank to suffer losses and become involved in time-consuming and expensive litigation.

The cost of credit loss insurance premiums was a significant cause of Guaranty's losses. Between 2008 and 2012, Guaranty paid approximately $105 million in credit loss insurance premiums. In 2009, Guaranty maintained credit loss insurance for only 24 percent of the value of its home equity loan portfolio at a cost of $34 million in premiums. Thus, most of this portfolio was not covered by credit loss insurance. In addition, much of the home equity portfolio was significantly under-collateralized due to a decline in real estate values. In 2009 alone, credit losses from its mortgage business and the increasing credit loss insurance premiums contributed to a net loss of $51 million. These factors continued to be the primary cause of Guaranty's operating losses and deteriorating capital beyond 2009.Guaranty's history of poor underwriting and risky lending caused a high level of problem assets, earnings insufficient to cover operating expenses, and depletion of capital.

In 2015, OCC examiners downgraded the bank's liquidity rating due to high risk profiles and weak liquidity risk management. The examiners noted that the bank used cash as the primary source for liquidity and had limited sources of contingency funding. In 2016, examiners concluded the bank's capital levels were not commensurate with its high credit, compliance, reputation, strategic, and operational risks, and that these risks relative to the bank's capital levels threatened the bank's viability. In 2017, OCC examiners

[7] Credit loss insurance protects businesses from non-payment of commercial debt.

noted that the bank's practice of pursuing a loan growth strategy based on significant concentrations in interest-only first mortgages and high-loan-to-value home equity loans without commensurate risk management or acceptable underwriting standards was an unsafe or unsound practice.

Deficient Supervision by the Board of Directors and Bank Management

Deficient supervision by the board of directors and bank management resulted in weak credit administration and management practices. The bank lacked the controls and staff necessary to manage the risks associated with high-risk mortgage lending, and bank management failed to provide adequate controls over lending practices. Bank management's inability to operate the bank profitably and increase capital continually concerned OCC examiners. Examiners considered management's failure to maintain adequate capital levels relative to the bank's risk profile an unsafe and unsound practice.

In 2013, OCC examiners noted that in some cases management failed to support the borrower's capacity to repay the loans underwritten by the bank. In some cases, management relied heavily on borrowers being able to repay loans because the borrower would have paid off other debt, therefore allowing the borrower to apply those funds to repay loans from Guaranty. Additionally in 2016, OCC examiners determined the board's and management's accounting practices and policies were not in compliance with Generally Accepted Accounting Priniciples and that led to inaccurate books and records.

OCC's Office of Special Supervision continually characterized bank management as "critically deficient" in examination reports and in 2014 required the bank to add a qualified senior executive to strengthen the management team and to direct the bank's financial recovery.

OCC's Supervision of Guaranty Bank

In supervising problem banks,[8] OCC officials told us they generally try to rehabilitate the bank while simultaneously planning for possible closure. The determination to close a bank is based on statutory capital and safety and soundness grounds set forth in 12 USC 1821 *Insurance Funds*, but potential loss to the DIF is also a consideration. In supervising Guaranty, OCC officials told us they were concerned with the potential loss to the DIF. While rehabilitation was the goal, OCC's alternative strategy was to keep the bank open long enough to minimize the loss to the DIF.

The intent of PCA is to ensure that action is taken when an institution becomes financially troubled in order to prevent failure or minimize resulting losses, with the overall purpose of resolving problems at the least possible long-term loss to the DIF.

When the bank became critically undercapitalized for PCA purposes[9] in 2012, OCC planned to close the bank in accordance with the PCA.[10] At that time, Guaranty's board and management had been working on selling their mortgage subsidiary to generate capital. In the interest of minimizing the loss to the DIF, OCC requested, and FDIC approved, a 90-day extension on the closure so that the sale could be consummated. OCC expected the sale to bolster the bank's capital above the critically undercapitalized level. The sale was consummated in January 2013. The sale increased Guaranty's capital, but the bank was still considered undercapitalized for PCA purposes. At this point, OCC was still considering closing the bank, but decided not to because the bank's loan portfolio was improving. In addition, the bank had a plan to use the capital from the sale to get

[8] Prior to 2012, Guaranty was supervised by the Office of Thrift Supervision (OTS). OCC became the bank's regulator in July 2011 when it assumed regulatory responsibility for federal savings associations pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203). At that time, Guaranty was placed under the supervision of OCC's Office of Special Supervision, which oversees the supervision of OCC's critical problem midsize and community banks.

[9] PCA capital categories are well capitalized; adequately capitalized; undercapitalized; significantly undercapitalized; and critically undercapitalized.

[10] PCA requires the regulator to close the bank within 90 days after capital levels fall to the critically undercapitalized level, unless the regulator, with the concurrence of the FDIC, determines that other action would better achieve the purpose of the prompt corrective action statute, after documenting why the action would better achieve that purpose.

rid of troubled assets, which would have lessened the loss to the DIF upon closure.

From 2012 to 2017, the bank achieved profitability in only two fiscal years, due to revenue from non-recurring events,[11] without which the bank would have suffered losses.[12] The bank's continual operating losses, combined with its continual lack of sufficient capital, threatened its viability. The bank's management and board of directors were unable to eliminate the operating losses, raise capital, or control risks. Ultimately, OCC determined that the scope of the bank's problems were beyond the board of directors' and management's ability to manage or control and the bank was in an unsafe or unsound condition to transact business. In the interests of protecting Guaranty's depositors and the DIF, OCC decided to close the bank in May 2017.[13]

Overall, OCC's supervision strategy, to rehabilitate the bank while simultaneously planning for possible closure, was consistent with the purpose of PCA. However, that supervision did not prevent a material loss to the DIF. We found that OCC did not adequately review Guaranty's request for retention bonuses for PCA compliance and did not adequately review the yearly salary increases the bank gave to senior executive officers until 2017. In 2017, an OCC Problem Bank Specialist, who was new to the supervision team, identified and questioned the salary increases.

Table 1 summarizes the results of OCC's full-scope safety and soundness and limited-scope examinations of Guaranty from 2011 until the bank's closure.[14] In general, a matter requiring attention (MRA) is the lowest level supervisory response to a bank practice that deviates from sound governance.

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[11] Selling its mortgage subsidiary, loan sales, and insurance and litigation settlements.

[12] Since 2006, the bank suffered cumulative losses of $178 million.

[13] OCC closed the bank using statutory authority in 12 U.S.C. 1464 *Federal Savings Associations* based on the criteria set forth in 12 USC 1821 *Insurance Funds*.

[14] OCC conducted its examinations of Guaranty every twelve months in accordance with the timeframes prescribed in the Community Bank Supervision Examination Handbook.

Table 1: Summary of OCC's Examinations and Enforcement Actions for Guaranty Bank

		Examination Results			
Date started/ Type of Examination	Assets (in (billions)	CAMELS rating	Number of MRAs	Number of corrective actions	Enforcement actions
2/22/2011 Full-scope examination[15]	$1.3	4/444532	3	5	2009 Cease & Desist Order[16] remained in effect
6/11/2012 Full-scope examination	$1.2	5/555544	7	12	2009 Cease & Desist Order remained in effect
6/10/2013 Full-scope examination	$1.2	5/555533	5	6	2009 Cease & Desist Order remained in effect
6/30/2014 Full-scope examination	$1.1	5/555523	3	6	2009 Cease & Desist Order remained in effect & 2014 PCAD[17]
5/26/2015 Full-scope examination	$1.1	5/555533	7	7	2009 Cease & Desist Order & 2014 PCAD remained in effect
5/31/2016 Full-scope examination	$1.0	5/555533	10	17	2009 Cease & Desist Order & 2014 PCAD remained in effect
11/28/2016 Limited-scope examination	$1.0	5/555533	11	3	2017 PCAD replaced the 2009 Cease & Desist Order and the 2014 PCAD

[15] Last examination conducted by OTS prior to OCC becoming the bank's regulator in July 2011.

[16] Effective March 11, 2009, Guaranty entered into a Stipulation and Consent to the Issuance of an Order to Cease and Desist with OTS. The 2009 Cease and Desist Order was based on OTS's findings that, among other things, Guaranty had engaged in unsafe or unsound practices, including operating with high levels of adversely classified assets and inadequate policies and procedures that resulted in poor earnings and diminished capital.

[17] A prompt corrective action directive (PCAD) is a formal enforcement action used against a bank under the PCA provision of the FDIA. It is a more severe form of formal enforcement action than a Cease and Desist Order.

OCC Did Not Adequately Review Guaranty's Request for Retention Bonuses for PCA Compliance Prior to Providing a Determination of No Supervisory Objection

In November 2012, Guaranty requested OCC's approval of a compensation plan for senior leaders. The plan consisted of a retention bonus and a performance bonus. In February 2013, OCC's Director of Special Supervision provided a NSO letter which stated OCC's non-objection to Guaranty offering a retention bonus program, but OCC did object to the proposed performance bonus plan. The retention bonuses were paid to several executive vice presidents in quarterly installments in 2013 and 2014. At the time, the bank was undercapitalized and had failed to submit to OCC an acceptable capital restoration plan (CRP),[18] therefore the retention bonuses awarded to the executive vice presidents violated the PCA provision of the FDIA.

In addition, Guaranty paid sign-on, performance (different from those requested in November 2012) and candidate referral bonuses to several executive vice presidents which also violated the PCA. Guaranty did not request approval from OCC to award these bonuses and OCC was unaware that these bonuses had been made at the time of payment. OCC did not learn about these bonuses until March 2017.

PCA prohibits paying any bonuses to senior executive officers if a bank is undercapitalized and has failed to submit an acceptable CRP. In defining "*senior executive officer,*" PCA defers to the definition of "*executive officer*" in 12 CFR 215 *Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks* (Regulation O). The Regulation O definition of executive officer includes every vice president, unless that person was formally excluded from the decision-making process by the bank's bylaws or a resolution from the board of directors.[19]

[18] PCA requires undercapitalized banks to submit a CRP to regulators. PCA explicitly describes the required content of the CRP and the criteria under which the regulator must either accept or reject the plan. The bank became undercapitalized in March 2012 and was never able to submit an acceptable CRP, despite several attempts.

[19] We found no such board resolution covering the scope of our review; and the bank's bylaws do not exclude any vice presidents from the decision-making process.

OCC's guidance, *Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution* and Policies and Procedures Manual (PPM) 5310-3 *Enforcement Action Policy*, is consistent with PCA in prohibiting bonuses to senior executive officers when a bank is undercapitalized and has not submitted an acceptable CRP. However, this guidance lacks specific procedures for OCC examiners to perform to monitor any bonuses paid to the senior executive officers in banks that are subject to PCA restrictions.

Prior to OCC's NSO for the retention bonuses, Guaranty submitted to OCC a PowerPoint presentation detailing the retention bonus plan and a performance bonus plan in support of the bank's request. In the presentation, Guaranty stated three times that the bonuses would be paid to "senior leaders," and only explicitly excluded two senior executive officers from the proposed bonus programs. Based on this wording, we believe it would have been prudent for OCC to either have determined specifically which employees would receive the bonus prior to providing the NSO or to have followed-up after the bank paid the bonuses to determine whether they were subject to the PCA prohibition.

The OCC Examiner-in-Charge was aware of the retention bonuses, but was not involved in the NSO process and could not answer any questions about the bonuses. This Examiner-in-Charge also told us that she did not follow-up to determine if the bonuses were subject to the PCA prohibition.

An OCC Problem Bank Specialist who was involved in the NSO process told us that the bank provided a list of employees who were going to receive the bonuses. However, the Problem Bank Specialist could not produce the list, nor is the list included in OCC's examination file. This same person also told us that he did not follow-up to determine whether the bonuses were subject to the PCA prohibition and was unaware if anyone else did.

We believe OCC's examiners did not take prudent steps to (1) determine which employees would receive a retention bonus prior to the NSO letter to ensure compliance with the PCA; (2) follow-up once the bonuses were awarded to verify whether the retention bonuses were subject to the PCA prohibition; and (3) review senior executive compensation for other bonuses to determine compliance with the PCA.

As a result, Guaranty was able to divert $192,000 in capital that could have been used to rehabilitate the bank or mitigate the loss to the DIF upon closing.

OCC Did Not Adequately Review the Salaries of Guaranty's Senior Executive Officers for PCA Compliance and Did Not Detect Until 2017 That Guaranty Gave Prohibited Yearly Salary Increases to Senior Executive Officers

Between 2012 and 2016, several Guaranty executive vice presidents received yearly increases in base salary. As the bank was undercapitalized and had not submitted an acceptable CRP to OCC to restore capital during this time, the increases in base salary violated the PCA provision of the FDIA.

PCA prohibits banks that are undercapitalized and fail to submit to the federal regulator an acceptable CRP from providing compensation to any senior executive officer at a rate exceeding that officer's average rate of compensation (excluding bonuses, stock options, and profit-sharing) during the 12 calendar months preceding the calendar month in which the institution became undercapitalized. The definition of "senior executive officer" is the same as defined in the prior section of this report on retention bonuses.

OCC guidance, *Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution* and PPM 5310-3 *Enforcement Action Policy* is consistent with the PCA in prohibiting salary increases to senior executive officers when a bank is undercapitalized and has not submitted an acceptable CRP. However, the guidance lacks specific procedures for examiners to perform to monitor any increases to senior executive officers' salaries in banks that are subject to PCA restrictions.

Guaranty provided a listing of senior executive salaries, including position titles, to OCC every year during the examination process. In addition, OCC supervisory file documentation shows Guaranty's board of directors discussed and approved salary increases at various times from 2011-2015:

- *Board of Directors Meeting Minutes* dated November 1, 2011: The board discussed and approved a 2.8% merit increase for 2012;

- *Review of Board of Directors Meeting Minutes* dated December 15, 2014: The board discussed and approved a merit pool[20] of 2.25% for 2015; and

- *Board of Directors Meeting Minutes* dated November 2, 2015: The board discussed and approved a merit pool of 2% for 2016.

The Examiner-in-Charge told us that the salaries of Guaranty's senior executives were reviewed every year, but the examiner did not know if any received pay increases. The Problem Bank Specialist told us that senior management salaries are reviewed periodically, but that there was no regular tracking process for reviewing them and that he did not review the salaries for PCA compliance.

In March 2017, OCC noticed that senior executive officers received increased compensation that would be prohibited by the bank's PCA restrictions based on information provided to examiners during an interim examination in 2016. As a result, OCC requested that Guaranty provide compensation information for the bank's Regulation O designated officers. Based on OCC's supervisory file and the examiner's admission that senior executive salaries were reviewed every year, we believe that OCC should have detected much sooner the salary increases for Guaranty's senior executive officers that violated PCA.

OCC's examiners did not adequately review senior executive salaries to determine compliance with PCA. As a result, Guaranty was able to divert $276,926 in capital that could have been used to rehabilitate the bank or mitigate the loss to the DIF upon closing.

OCC's Use of Prompt Corrective Action

The purpose of PCA is to resolve problems of insured depository institutions with the least possible long-term loss to the DIF. The PCA requires federal banking agencies to take certain actions when an institution's capital drops below certain levels. Depending on the capital level, some PCA restrictions are imposed automatically, and others are discretionary. PCA requires regulators to take prompt

[20] A merit pool is the total amount of money available for salary increases.

corrective action to resolve an insured institution's problems once a bank becomes undercapitalized.

According to OCC guidance, *Enforcement Action Policy* PPM 5310-3, the use of a PCA directive (PCAD) is preferred over other enforcement actions when a bank is undercapitalized and its viability is in doubt.

Based on Guaranty being significantly undercapitalized and failing to submit an acceptable CRP, OCC issued a PCAD in April 2014. In addition to imposing PCA requirements and restrictions, the PCAD also reinforced the requirements and restrictions of the cease & desist order imposed by OTS in 2009. Guaranty was never able to achieve full compliance with either the cease and desist order or the PCAD.[21] OCC documented the status of the bank's efforts to comply with both the 2014 PCAD and 2009 cease and desist order in each examination report from 2011 through 2016.

Recommendation

We recommend that the Comptroller of the Currency develop and document examination procedures, for banks subject to PCA restrictions, that are designed to identify and track all types of compensation paid to executive officers (as defined in Regulation O). The implementation of documented examination procedures for identifying and tracking executive officer compensation (salary, bonuses, etc.) will enhance compliance monitoring of compensation restrictions.

Management Response

Management concurred with the recommendation. OCC will continue to follow its longstanding practice of notifying banks of their responsibility to adhere to the restrictions applicable to them based on their PCA capital category, including restrictions on compensation. Also, OCC commits to developing internal procedures that create standards for problem bank specialists to monitor all types of compensation paid to executive officers for compliance with appropriate PCA restrictions. OCC will finalize the new standards and

[21] In February 2017, OCC issued a new PCAD which terminated and replaced both the 2009 cease & desist order and the 2014 PCAD.

provide training to problem bank specialists by January 31, 2018. Further, OCC is updating its internal *Examiners' Guide to Problem Bank Supervision* and will expand the *Examiners' Guide* to include a more comprehensive section on compliance with PCA restrictions. OCC plans to finalize and internally publish the *Examiners' Guide* to all OCC employees by September 30, 2018.

In addition, OCC responded that its decision to approve the retention bonuses was part of the rehabilitation strategy and that the bonuses were instrumental to the consummation of the sale of Guaranty's mortgage subsidiary, which ultimately reduced the loss to the DIF in excess of the cost of the bonuses. OCC also commented that "In hindsight, the OCC concludes that providing a determination of NSO for the retention bonuses would have been appropriate even when considering the PCA restrictions."

OIG Comments

Management's planned actions meet the intent of our recommendation.

While we have no basis to question whether the retention bonuses were part of the rehabilitation strategy and instrumental to the sale of the mortgage subsidiary, PCA prohibits paying any bonuses to senior executive officers if a bank is undercapitalized and has failed to submit an acceptable CRP.[22] As stated earlier in this report, we believe OCC's examiners did not take prudent steps to (1) determine which employees would receive a retention bonus prior to the NSO letter to ensure compliance with the PCA; (2) follow-up once the bonuses were awarded to verify whether the retention bonuses were subject to the PCA prohibition; and (3) review senior executive compensation for other bonuses to determine compliance with the PCA.

* * * * *

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 or Andrew Morgan, Audit Manager, at (202) 927-8121. Major contributors to this report are listed in

[22] 12 U.S.C. 1831o(f)(4)(B)

appendix 4. A distribution list for this report is provided in appendix 5.

/s/

Jeffrey Dye
Director, Financial Regulation and Oversight

We conducted a material loss review of Guaranty Bank (Guaranty), located in Milwaukee, Wisconsin, in response to our mandate under section 38(k)[23] of the Federal Deposit Insurance Act. This section provides that if the Deposit Insurance Fund 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 insurance fund;
- 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.

At the time of Guaranty's failure on May 5, 2017, section 38(k) defined a loss as material if it exceeded $50 million. The law also requires the inspector general to complete the report within 6 months after it becomes apparent that a material loss to the Deposit Insurance Fund has been incurred. We initiated this material loss review of Guaranty based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC), which was $146.4 million at the time of closing. As of September 30, 2017, FDIC estimated that the loss would be $148.6 million.

To accomplish our reporting objectives under section 38(k), we conducted fieldwork from May 2017 through October 2017 at the Office of the Comptroller of the Currency's (OCC) headquarters in Washington, DC and at FDIC's offices in Arlington, Virginia.

To assess the adequacy of OCC's supervision of Guaranty, we determined (1) when OCC first identified the bank'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

[23] 12 U.S.C. § 1831o.

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 period covered by our audit would be from February 2011, through the bank's failure on May 5, 2017. This period included six full-scope safety and soundness examinations, and one limited-scope examination of Guaranty by OCC.

- We reviewed OCC's supervisory files and records for the bank from 2011 through 2017. 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 action used by OCC to compel bank management to address deficient conditions. 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 the supervision with OCC officials, examiners, and attorneys to obtain their perspectives on the bank's condition and the scope of the examinations.

- We selectively reviewed Guaranty documents that had been taken by FDIC and inventoried by FDIC's Division of Resolutions and Receivership personnel upon receivership. From FDIC's inventory list, we identified documents for our review that were most likely to shed light on the reasons for the bank's failure and OCC's supervision of the institution.

- We assessed OCC's actions based on its internal guidance and the requirements of the Federal Deposit Insurance Act.[24]

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

[24] 12 U.S.C. § 1811 et seq.

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.

Guaranty Bank History

Guaranty Bank (Guaranty) was a federally chartered thrift located in Milwaukee, Wisconsin, that was under a two-tier holding company structure. The institution was established in 1923 and became insured June 2, 1939. Guaranty converted from a state-chartered savings bank to a federal stock savings bank on June 3, 2002. The bank had 119 branches located in Wisconsin, Michigan, Minnesota, Illinois, and Georgia, of which 108 were in supermarkets. These branches were the bank's primary source of funding through retail deposit gathering. As of March 31, 2017, the bank had total assets of approximately $1 billion. The bank was closed on May 5, 2017, with an expected loss to the Deposit Insurance Fund of $146.4 million. As of September 30, 2017, FDIC estimated that the loss would be $148.6 million

From 2005 to 2007, Guaranty's board of directors and management adopted a more aggressive business model for lending than previously followed. The bank began to offer "alternative" first mortgages, also known as "Alt-A" loans, that were considered prime quality but had some unique features, such as being interest-only.

In 2008 alone, Guaranty's loan portfolio included $849 million in home equity loans. As of 2009, home equity loans represented 53 percent of Guaranty's total assets. As of March 2011, 90 percent of Guaranty's home equity loans were secured as second liens. The losses Guaranty suffered from these loans significantly contributed to its overall losses, which totaled approximately $191 million from 2006-2012. During that period, Guaranty's total assets declined by $629 million and its leverage capital ratio fell from 10 percent (well capitalized for Prompt Corrective Action purposes) to less than 2 percent (critically undercapitalized for Prompt Corrective Action purposes). Although capital increased somewhat in early 2013 due to the sale of its mortgage subsidiary, the bank's continual operating losses, combined with its lack of sufficient capital, continually threatened its viability and the bank was a candidate for closure for several years prior to closure in 2017. At the time of closure, Guaranty's leverage capital ratio was just above 2 percent.

Office of the Comptroller of the Currency

Washington, DC 20219

December 19, 2017

Jeffrey Dye
Director, Banking Audits
Office of Inspector General
Department of the Treasury
Washington, DC 20220

Subject: Response to Draft Report

Dear Mr. Dye:

We have received and reviewed your draft report titled "Material Loss Review of Guaranty Bank," (Guaranty) of Glendale, Wisconsin. Section 38(k) of the Federal Deposit Insurance Act mandates this review because of the amount of the bank's estimated loss to the Deposit Insurance Fund (DIF). Your objectives were to determine the causes of Guaranty's failure; assess the Office of the Comptroller of the Currency's (OCC) supervision of the bank, 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, you reviewed OCC and Federal Deposit Insurance Corporation files and interviewed OCC officials.

In your report you concluded that Guaranty failed primarily because of relaxed loan underwriting standards, poor risk management, and deficient supervision by the board of directors and bank management.

Regarding supervision, OCC examiners generally followed guidance in supervising Guaranty; however, that supervision did not prevent a material loss to the DIF. You found that the OCC did not adequately review (1) Guaranty's request for retention bonuses for PCA compliance prior to providing a determination of no supervisory objection (NSO);[1] and (2) the salaries of Guaranty's senior executives, and therefore did not detect until 2017 that Guaranty gave senior executive officers yearly salary increases that were prohibited by PCA. As a result, the bank paid $468,926 in bonuses and salary increases to senior executive officers that the OCC did not review for compliance with applicable PCA restrictions.

We concur with these findings because, as a technical matter, they are factually correct. It is important to note for the factual record that the OCC decision to approve the retention bonuses was part of the rehabilitation strategy that your report summarizes in the section on the OCC's Supervision of Guaranty Bank. In the OCC's opinion, the retention bonuses were instrumental to

[1] The OCC uses the term "no supervisory objection" to convey that they do not find a compelling supervisory or regulatory reason to deny the request. The OCC does not consider an NSO to be an "approval."

the consummation of the sale of the mortgage subsidiary, which ultimately reduced the loss to the DIF well in excess of the $192,000 cost of the retention bonuses. In hindsight, the OCC concludes that providing a determination of NSO for the retention bonuses would have been appropriate even when considering the PCA restrictions. The report also correctly notes that the OCC disapproved bonus payments to the key senior executive officers that the OCC determined were primarily responsible for the bank's deficient condition. Finally, the report notes that the OCC discovered the salary increases in violation of the PCA restrictions in 2017. In the OCC's opinion, there is insufficient evidence to conclude that all of the salary increases were in violation of the PCA restrictions. The OCC was gathering information from the bank, but did not complete its review due to the bank's failure on May 5, 2017.

Your report recommends the Comptroller of the Currency develop and document examination procedures, for banks subject to PCA restrictions, that identify and track all types of compensation paid to executive officers as defined in 12 CFR 215 *Loans to Executive Officers, Directors, and Principle Shareholders of Member Banks,* also known as Regulation O.[2] The implementation of documented examination procedures for identifying and tracking executive officer compensation (salary, bonuses, etc.) will enhance compliance monitoring of compensation restrictions. We concur with the recommended corrective action.

The OCC has a longstanding practice of notifying banks of their responsibility to adhere to the restrictions applicable to them based on their PCA capital category, including restrictions on compensation. We will continue to follow the longstanding practice, using established templates for PCA capital category notification letters.

We further commit to developing internal procedures that create standards for problem bank specialists to monitor all types of compensation paid to executive officers for compliance with appropriate PCA restrictions. We will finalize the new standards and provide training to problem bank specialists by January 31, 2018.

Additionally, we are updating the OCC's internal *Examiners' Guide to Problem Bank Supervision*. We will expand the *Examiner's Guide* to include a more comprehensive section on compliance with PCA restrictions. We plan to finalize and internally publish the Examiners' Guide to all OCC employees by September 30, 2018.

[2] Regulation O is a regulation promulgated by the Board of Governors of the Federal Reserve System and it governs any extension of credit by a member bank to an executive officer, director, or principal shareholder of that bank, of a bank holding company of which the member bank is a subsidiary, and of any other subsidiary of that bank holding company. The regulation was referenced as a source to define senior executives for this recommendation.

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If you need additional information, please contact Toney Bland, Senior Deputy Comptroller for Midsize and Community Bank Supervision, at 202-649-5420.

Sincerely,

/S/

Joseph M. Otting
Comptroller of the Currency

3

Andrew Morgan, Audit Manager
David Hash, Auditor-in-Charge
Angela Brice, Auditor
Katherine Draper, Auditor
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Department of the Treasury

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Office of Strategic Planning and Performance Improvement
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