Audit Report

OIG-14-033

SAFETY AND SOUNDNESS: Material Loss Review of First National Bank

April 17, 2014

Office of Inspector General

Department of the Treasury

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Abbreviations

FAS	Financial Accounting Standards
FDIC	Federal Deposit Insurance Corporation
GAAP	Generally Accepted Accounting Procedures
MRA	matter requiring attention
OCC	Office of Comptroller of the Currency
OIG	Office of Inspector General
PCA	prompt corrective action
ROE	report of examination

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Audit Report

The Department of the Treasury
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April 17, 2014

Thomas J. Curry
Comptroller of the Currency

This report presents the results of our material loss review of the failure of First National Bank (First National), Edinburg, Texas, and of the Office of the Comptroller of the Currency's (OCC) supervision of the institution. OCC closed First National and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on September 13, 2013. Section 38(k) of the Federal Deposit Insurance Act mandated this review because of the magnitude of the bank's estimated loss to the Deposit Insurance Fund.[1,2] As of February 28, 2014, FDIC estimated that loss at $637.5 million.

The objectives of our review were to determine the causes of the bank's failure; assess OCC's supervision of the bank, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing any such loss in the future. To accomplish these objectives, we reviewed the supervisory files and interviewed OCC and FDIC 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 First National's history and OCC's assessment fees and examination hours.

1 Effective July 21, 2010, section 38(k) defines a loss as material if it exceeds $150 million for calendar years 2012 and 2013 and $50 million for calendar years 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met).

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

In brief, our review found that First National failed primarily because of (1) aggressive growth resulting in a high-risk concentration of commercial real estate loans (CRE) and (2) undue influence by the former chairman of the board and deficient senior management oversight and governance. Regarding supervision, OCC examiners generally followed guidance in supervising First National; however, that supervision did not prevent a material loss to the Deposit Insurance Fund. We did find that OCC did not identify until 2013 (1) First National's potentially improper accounting of 2009 capital injections and (2) First National's practice of improperly accounting for interest income on nonaccrual loans using the cash-basis method. OCC closed a matter requiring attention (MRA) in 2010 without sufficient evidence that bank management had corrected the problem. OCC did make appropriate use of PCA.

As a result of our audit, we referred certain matters to the Treasury Inspector General's Office of Investigations.

We are recommending that OCC remind examiners to follow guidance in the OCC (1) ***Capital Accounts and Dividends*** booklet regarding the documentation of material changes in a bank's capital accounts and (2) ***Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution*** booklet regarding watching for aggressive accounting positions taken by management. We are also recommending that OCC expand its examiner guidance in the ***Loan Portfolio Management*** booklet to provide instructions regarding the proper accounting treatment for nonaccrual loans.

In a written response, which is included as appendix 3, OCC provided its planned corrective actions which we consider responsive to our recommendations. However, OCC will need to record the planned completion dates for taking these actions in the Joint Audit Management Enterprise System (JAMES), the Department of the Treasury's audit recommendation tracking system.

Causes of First National Bank’s Failure

Aggressive Growth Resulting in a High Concentration of CRE

OCC defines a concentration risk as risk in a loan portfolio that arises when a disproportionate number of an insured depository institution’s loans are concentrated in one or a small number of financial sectors, geographical areas, or borrowers. Contrary to safe and sound practices, First National’s board and management pursued a growth strategy which permitted significant concentrations in CRE without commensurate risk management practices. This aggressive growth strategy began in 2001, with the bank’s total assets increasing approximately 22 percent per year, peaking in mid-2008 at $4.6 billion. Additionally, the bank grew its branches from 17 locations in 1999 to 64 locations in 2009. As a result of this strategy, by June 30, 2008, First National’s CRE concentration as a percent of Tier 1capital plus allowance for loan and lease losses (ALLL) had increased to 531 percent.

During this rapid growth, the board and management failed to institute credit administration policies, procedures and practices commensurate with the growth of the portfolio and increased risk. When underwriting its CRE loans, First National emphasized low loan-to-value (LTV) ratios and failed to adequately consider borrowers' sources of cash flow or liquidity to support loan repayment. The board and management's deficient oversight and failure to adjust quickly or effectively to changing economic conditions and the declining real estate market resulted in deterioration of the bank's asset quality; increased loan loss provisions and net losses; and dissipation of capital. First National fell to the critically undercapitalized PCA capital category effective July 30, 2013. OCC subsequently closed First National on September 13, 2013, and appointed FDIC as receiver.

Undue Influence by the Former Chairman of the Board and Deficient Senior Management Oversight and Governance

According to OCC examiners, the former chairman of the board[3] of First National exerted undue influence on the operations of the bank. For example, the bank purchased $300 million of investments in Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Association (Freddie Mac) as well as other financial institutions in 2008.[4,5] OCC determined that the former chairman exerted undue influence in the purchase and subsequent sale of the investments. The bank's divestiture of these investments resulted in a $174 million loss in the third quarter of 2008. This loss triggered the need for additional capital.

An OCC examiner also stated that shortly before the bank failed, a First National loan officer revealed to him that there had been undue pressure from executive management to change loan risk ratings to show a more positive condition. Examiners noted several instances where the bank personnel identified factors in loans that indicated a substandard credit, but the loan risk rating would not be changed. As discussed in greater detail below, bank management delayed recognition of problem loans and associated losses, and that improper loan risk ratings was a recurring issue since the 2006 examination. Also, in 2011, OCC examiners determined that bank management masked problems associated with financing other real estate owned (OREO) sales.

As a result of the 2010 examination, OCC examiners concluded that deficient senior management oversight or understanding of

[3] The bank's board of directors asked the chairman to resign in September 2011. His resignation was effective November 1, 2011.

[4] Law and regulatory standards permit banks to purchase Fannie Mae and Freddie Mac securities without limitation; specifically, 12 U.S.C. 24 (Seventh) and OCC implementing guidance in 12 C.F.R. Part 1, *Investment Securities*.

[5] 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. These two GSEs operate solely in the mortgage market and were therefore very much exposed to fluctuations in the housing market. Fannie Mae and Freddie Mac were placed into conservatorship by the Federal Housing Finance Agency on September 7, 2008.

technical credit administration practices had resulted in poor credit administration practices. Some of those practices included poor credit classification, weak underwriting and credit analysis, as well as inappropriate and untimely appraisals. As the loan portfolio experienced turnover, the development of a management structure to properly oversee credit administration was not a primary concern of the board and management. Prior to 2010, the senior lending officer was responsible for credit administration. However, OCC examiners concluded that structure did not ensure proper independence or governance over the lending area. An MRA issued as a result of this examination required, among other things, that the board hire a chief credit officer to oversee credit administration.

OCC's Supervision of First National Bank

Overall, OCC examiners generally followed guidance in supervising First National; however, that supervision did not prevent a material loss to the Deposit Insurance Fund. We did find that while OCC discovered serious issues with First National in 2013, we believe these issues, specifically, First National's potentially improper accounting of the 2009 capital injections and its income recognition on nonaccrual loans, could have been discovered sooner. Also, OCC closed an MRA without sufficient evidence that bank management had corrected the problem.

Table 1 summarizes the results of OCC's full-scope safety and soundness and limited-scope examinations of First National from 2007 until the bank's closure.[6] In general, an MRA, although not an enforcement action, is a stronger supervisory response than a corrective action.

[6] OCC conducted its examinations and performed off-site monitoring of First National in accordance with the timeframes prescribed in the OCC Examination Handbook.

Table 1: Summary of OCC's Examinations and Enforcement Actions for First National

		Examination Results			
Date started/ type of exam	Assets (in (billions)	CAMELS rating	Number of MRAs	Number of corrective actions	Enforcement actions
9/10/2007 Full-scope examination	$3.9	2/222221	0	0	None
9/1/2008 Full-scope examination	$4.3	3/333322	6	0	Memorandum of understanding (MOU) (1/27/2009) Individual minimum capital ratio (IMCR) (2/19/2009)
8/17/2009 Full-scope examination	$3.8	3/343322	5	0	MOU and IMCR remained in effect.
5/25/2010 Targeted examination	$3.8	3/343322	0	0	MOU and IMCR remained in effect.
8/16/2010 Full-scope examination	$3.9	4/444333	6	7	Consent order #1 (2/8/2011)
5/16/2011 Targeted examination	$3.8	4/444333	0	0	Consent order #1 remained in effect.
8/1/2011 Full-scope examination	$3.7	5/455543	18	6	Consent order #2 (1/18/2012)
3/2012 Targeted examination	$3.5	5/455543	1	0	Consent order #2 remained in effect.
8/13/2012 Full-scope examination	$3.5	5/555544	9	3	PCA directive (8/30/2013)
3/2013 Targeted examination	$3.3	5/555554	1	0	Consent order #2 and PCA directive remained in effect.

Source: OCC supervisory files.

OCC Did Not Identify First National Bank's Potentially Improper Accounting of 2009 Capital Injections Until 2013

OCC's ***Capital Accounts and Dividends*** booklet instructs examiners to review material changes in a bank's capital accounts. Records detailing the number of shares authorized, issued, unissued, and the par value for each class of stock should be maintained in the examination working papers. Additionally, examiners should investigate changes in these items to determine that necessary approvals have been obtained and that the articles of association have been amended as required.

OCC booklet ***An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution*** reminds examiners that some problem banks may attempt to reduce losses or increase income inappropriately. The guide states that if improper accounting principles are applied, significant misstatement of financial results and regulatory capital may occur. Therefore, examiners are instructed to watch for aggressive accounting positions taken by management, such as banks inappropriately increasing capital by selling stock in exchange for loans. The guide states such notes received in exchange for capital stock should not be recorded as assets. Rather, generally accepted accounting principles (GAAP) requires that such loans be recorded as a deduction from stockholders' equity, unless they are secured by irrevocable letters of credit or other liquid assets (e.g., certificates of deposit) and are paid within a reasonably short period of time (i.e., 90 days or less). Hence, the increase in capital is reduced by the amount of the notes received as payment for the stock.

As of December 31, 2008, First National's capital ratios were 6.32 percent for Tier 1 leverage and 9.6 percent for total risk-based capital. In February 2009, pursuant to its authority[7] and due to First National's increased credit risk and reduced capital, OCC established an individual minimum capital ratio (ICMR) for the bank. The IMCR required First National to hold the higher minimum capital ratios of 8 percent Tier 1 leverage and 12 percent total risk-based capital. Later in 2009, OCC examiners noted that First National had received two capital injections

[7] 12 U.S.C. § 3907(a)(2) and 12 C.F.R. Part 3, Subpart C

from the bank's holding company in 2009 that totaled $35 million, and reported that the Tier 1 leverage and total risk-based capital ratios were 8.93 percent and 12.35 percent respectively, as of September 30, 2009.

In 2013, after the bank closed, OCC examiners learned from FDIC investigators that holding company shareholders obtained loans from First National in 2009 and may have used the proceeds to purchase holding company stock. Funds from a holding company stock sale were down-streamed to the bank and reflected as capital on the bank's call report. This would be contrary to GAAP and OCC's ***An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution*** if the stock sale proceeds prove to have come from First National loans. If the bank financed the sale of holding company stock by issuing unsecured loans to the purchasers of the shares, then the bank's capital should not have been increased as a result of the stock sale. At the time of our material loss review, OCC was continuing its review of the capital injections to determine their source, and had identified approximately $26 million in capital that potentially should not have been counted as Tier 1 capital in 2009. If this $26 million had not been counted as capital in 2009, the bank's total risk-based capital ratio would have been 11.53 percent in September 2009, falling short of the IMCR requirement of 12 percent for total risk-based capital. According to OCC officials, if confirmed, this exclusion from Tier 1 capital would not have had a significant impact on First National's ratings or the OCC's enforcement actions at that time.

In 2009, other than noting that the capital was received from the holding company, examiners did not document in the working papers, the material changes in First National's capital accounts as a result of the capital injections totaling $35 million, in accordance with the ***Capital Accounts and Dividends*** booklet. In light of the fact that First National was required to hold higher capital ratios as discussed above, we asked OCC officials why examiners did not consider the possibility that bank management inappropriately increased capital by selling stock in exchange for loans. OCC officials stated this possibility was not considered at the time because the bank had previously received capital injections from the holding company and there were no red flags regarding the 2009 capital injections that would have led examiners to do so. While we recognize the judgment exercised by the examiners, we believe the examiners should have drilled down on the source of these injections in line with the guidance in ***An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution.***

OCC Did Not Timely Identify Improper Accounting for Nonaccrual Loans

GAAP allows two alternative accounting treatments for nonaccrual loans: the cash-basis method and the cost-recovery method.[8] Under the cash-basis method, no interest income is accrued, but the interest portion of payments received may be recognized as interest income. This method is appropriate if the value of the loan (generally, the principal balance less any charge-offs) is expected to be fully collected. If there is doubt whether the loan will be collected, the cost-recovery method must be used, which requires payments received to be applied against principal, and no interest income is recognized.

Beginning in 2006 and continuing into 2013, OCC examiners noted issues related to First National's nonaccrual loans. OCC issued an MRA in 2006 requiring the bank to identify nonaccrual loans in a timely manner. This was followed by multiple MRAs from 2008 through 2011 on the same issue. In its 2009 MOU with the bank, OCC required the board to develop and implement a written policy governing both the identification of and the accounting treatment for nonaccrual loans. In the 2011 and 2012 consent orders, OCC required the board to revise the written credit policy to include procedures governing the identification and accounting for nonaccrual loans that are consistent with the requirements contained in the call report instructions.

Although OCC repeatedly required the bank to adopt or change policies governing the accounting for nonaccrual loans, First National, in fact, was not following GAAP in its accounting treatment for nonaccrual loans. OCC did not identify this practice until early 2013, when examiners discovered that the bank had been using cash basis accounting for nonaccrual loans

[8] Financial Accounting Standards Board Accounting Standards Codification 310-10-35

instead of the cost recovery method. When asked why this was not discovered sooner, examiners stated that nonaccrual loans typically do not receive steady or significant payments, so they focused on whether the bank was properly identifying nonaccrual loans not the accounting for payments received on nonaccrual loans.

OCC examiners discovered the improper accounting in 2013 by reviewing the payment histories for loans on nonaccrual, and finding that interest payments received were being recorded as income instead of being applied to reduce the principal loan balances. When examiners questioned the bank in 2013 regarding this practice, First National officials stated that the bank's practice of using cash basis accounting for nonaccrual loans had been in place for many years. OCC examiners determined that the improper cash basis accounting treatment for nonaccrual loans caused the bank to overstate earnings and capital for 2011, 2012, and the first quarter of 2013 by $1.4 million, $9.8 million, and $3.6 million, respectively. In a June 2013 letter to the board of directors, OCC required First National to immediately charge-off all interest income that had been recorded contrary to call report instructions governing nonaccrual loans, and to adhere to the bank's nonaccrual policies.

We noted that OCC's ***Loan Portfolio Management*** booklet does not have specific guidance to examiners regarding the accounting treatment for nonaccrual loans. However, the booklet ***An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution*** discussed above states that examiners should check to see whether recorded loan balances are fully collectible for those loans for which interest income is recognized on a cash basis. We believe the ***Loan Portfolio Management*** booklet should include similar language, and that examiners should not wait to review a bank's accounting treatment for nonaccrual loans until it becomes a problem bank.

OCC Closed an MRA in 2010 Without Sufficient Evidence

During the 2008 full-scope examination, OCC noted that First National's balance of OREO was $24 million. During the 2009 examination, OCC noted that the OREO balance had increased to $67 million as of July 31, 2009. Between the 2008 and 2009 examinations, the bank had sold $133 million of OREO. As a result of the 2009 examination, OCC issued an MRA regarding the bank's non-compliance with Statement of Financial Accounting Standards (FAS) 66, "Accounting for Sales of Real Estate." According to FAS 66, for a bank to accrue interest income when financing the sale of OREO, a viable sale must exist which includes loan terms that are commensurate with the market, and the requisite down payment.[9] Without each condition satisfied, the bank must account for the transaction according to one of four methods outlined within FAS 66, none of which allow for the accrual of interest income until the conditions are met.

During the 2009 examination, all five bank-financed OREO sales sampled by OCC had no down payments (i.e., no cash equity by the investor), yet the bank accrued interest income for these sales. OCC reported in its 2009 report of examination (ROE) that improper accounting for the bank's sales of OREO resulted in an overstatement of earnings. OCC did not quantify the overstatement of earnings from the improper accounting treatment for the five OREO financed loans it reviewed.

As part of the 2009 MRA, OCC required First National to review all OREO sales and determine if proper accounting had been applied. In a February 2010 letter from bank management, OCC received the results of the bank's review of only those OREO sales over $750,000. The letter stated that (1) the bank reviewed all gains recorded on OREO sales from August 2008 through December 2009, (2) gains of over $1 million should have been deferred, and (3) First National had recognized additional losses of more than $412,000 on the sale of OREO. While the bank appeared to have reviewed gains taken at the time of the OREO sales, the letter did not mention a review of accounting for accrued interest, which was the subject of the 2009 MRA.

In the same letter, bank management requested an exception to the MRA requirement to look at all OREO sales. Specifically,

[9] A requisite down payment is the appropriate minimum initial investment expressed as a percentage of the sales value based on the type of asset (e.g., land, commercial property, residential, etc.)

management requested to exclude from its review (1) all loans for 1-4 family residential homes less than $750,000 and (2) all other loans less than $250,000. This exclusion would have meant that more than half of OREO loans less than $750,000, worth a total of approximately $35.3 million, would not be reviewed for improper accounting. An OCC examiner told us that this request was not approved and that the bank did in fact review all OREO sales less than $750,000 and found no issues. However, unlike the review of loans over $750,000, there was no examination documentation to support the examiner's statement that the bank had reviewed all OREO loans.

During the 2010 examination, OCC evaluated FAS 66 compliance and noted that the bank's credit review area was completing a checklist when loans were made to finance the sale of OREO. OCC also noted that the checklist was comprehensive and provided guidance on the matter. The OCC examiner concluded the MRA had been addressed and closed the MRA in September 2010. However, there was limited evidence in the examination workpapers related to the work performed to reach this conclusion.

As a result of the 2011 examination, OCC again issued an MRA with respect to improper accounting issues regarding the bank's sales of OREO. Examiners determined that the bank had masked its OREO problems by financing OREO sales on liberal terms, capitalizing property taxes, and advancing funds on borrowers' other loans to cause the borrowers to remain current on OREO loans. The 2011 MRA expressed concerns over First National's aggressive strategy to sell OREO without implementing proper accounting policies and practices, and directed the board to make accounting adjustments and file amended call reports.

OCC's ***Bank Supervision Process*** booklet states that examiners should verify that the bank's corrective actions to address MRAs have been successful and timely. This includes verifying that the bank is executing the action plans and evaluating whether the actions the bank has taken or plans to take adequately address the deficiencies. We found limited examination documentation that showed OCC examiners verified the actions taken by the bank to address the 2009 MRA.

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 Deposit Insurance Fund. PCA requires federal banking agencies to take certain actions when an institution's capital drops below certain levels. PCA also gives regulators flexibility to supervise institutions based on criteria other than capital levels.

First National was adequately capitalized as of June 30 and September 30, 2012. Due to continued deterioration in asset quality and associated losses, the bank became significantly undercapitalized with the filing of its December 31, 2012, call report[10] and OCC detailed this in a letter to the bank dated January 31, 2013. The letter required First National to submit a capital restoration plan (CRP), which the bank submitted on March 15, 2013. In a letter to the bank dated April 30, 2013, OCC rejected the plan because OCC was unable to determine that the plan was realistic or likely to succeed in restoring First National's capital. Also, the plan did not contain information required for an acceptable CRP, including an explanation of how and when the bank would correct the unsafe or unsound banking practices that caused the bank's capital to become impaired. First National never submitted an acceptable plan. In a letter dated August 1, 2013, OCC informed First National that its capital level was critically undercapitalized with the filing of its June 30, 2013, call report.

OCC issued a PCA directive to First National on August 30, 2013, which included provisions to, among other things, preserve the bank's assets, books, and records. Because of First National's failure to submit a viable capital restoration plan and the substantial dissipation of the bank's assets and earnings, OCC placed First National into receivership. As First National's capital fell below adequately capitalized, we believe OCC took appropriate action within its PCA authorities.

[10] The December 31, 2012 call report originally showed the bank to be significantly undercapitalized with a total risk-based capital ratio of 5.59 percent and a leverage ratio of 3 percent. On April 18, 2013, First National filed an amended call report for December 31, 2012. The amended call report also showed the bank to be significantly undercapitalized with a total risk-based capital ratio of 4.85 percent and a leverage ratio of 2.47 percent.

Recommendations

In our June 2012 In-Depth Review of the First National Bank of Davis, Davis Oklahoma, we recommended that OCC remind examiners of the importance of following OCC's guidance regarding verifying that the bank's corrective actions have been successful and timely.[11] In its response to this 2012 recommendation, OCC committed to reinforce the expectation for its examiners to comply with all aspects of the ***Midsize and Community Bank Supervision MRA Reference Guide***[12] that was distributed on July 1, 2010. OCC reported that this corrective action had been implemented as of February 2013, referencing a message that was sent to all employees on February 11, 2013. We note that OCC's closure of the 2009 MRA occurred prior to this February 2013 message. Ensuring examiners verify that banks properly address MRAs is a matter requiring on-going OCC management attention; accordingly, we making no new recommendations in this area from our material loss review of First National.

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

1. Remind examiners to follow OCC guidance in the (a) ***Capital Accounts and Dividends*** booklet regarding the documentation of material changes in a bank's capital accounts and (b) ***Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution*** booklet regarding watching for aggressive accounting positions taken by management.

   Management Response

   As part of OCC's ongoing discussions of lessons learned with managers, OCC will share this finding and direct them to ensure that material changes in a bank's capital account

[11] *Safety and Soundness: In-Depth Review of the First National Bank of Davis, Davis, Oklahoma*, OIG-12-055 (June 7, 2012).

[12] The *Midsize and Community Bank Supervision MRA Reference Guide*, June, 2010, is designed to strengthen compliance with the policies and procedures of the OCC governing MRA criteria, reporting, follow-up, and recordkeeping.

are properly documented. OCC will also discuss this topic during the next nationwide call with all midsize and community bank examiners.

OIG Comment

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

2. Expand examiner guidance in the ***Loan Portfolio Management*** booklet to provide instructions regarding the proper accounting treatment for nonaccrual loans, including the accounting for payments received on these loans.

   Management Response

   OCC stated that an update of the "Loan Portfolio Management" booklet is scheduled to begin later this year with publication in early 2015. OCC notes, however, that relevant guidance on this topic can also be found in the OCC's "Rating Credit Risk" booklet, the Federal Financial Institutions Examination Council's Call Report Instructions, and the OCC's Bank Accounting Advisory Series.[13] The Bank Accounting Advisory Series is updated annually and the most recent update included an expanded discussion of how to treat cash payments for nonaccrual loans.

   OIG Comment

   To the extent that the planned update to the booklet addresses the proper accounting treatment for nonaccrual loans, management's proposed action is responsive to the recommendation. OCC will need to record its planned completion date for taking corrective action in JAMES.

[13] Auditor's note: The Federal Financial Institutions Examination Council is a formal interagency body empowered under 12 U.S.C. Chapter 34, Federal Financial Institutions Examination Council, to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the Consumer Financial Protection Bureau, FDIC, the National Credit Union Administration, and OCC.

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We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-0384 or Theresa Cameron, Audit Manager, at (202) 927-1011. Major contributors to this report are listed in appendix 4.

Jeffrey Dye /s/
Audit Director

We conducted a material loss review of First National Bank (First National), Edinburg, Texas, in response to our mandate under section 38(k) of the Federal Deposit Insurance Act.[14] 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 First National's failure on September 13, 2013, section 38(k) defined a loss as material if it exceeded $150 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 First National based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC), which was $637.5 million at the time of closing. As of February 28, 2014, FDIC estimated that the loss would be $637.5 million.

To accomplish our reporting objectives under section 38(k), we conducted fieldwork at OCC's headquarters in Washington, D.C.; OCC's district office in Dallas, Texas; and FDIC's regional office in Dallas, Texas. We conducted our fieldwork from November 2013 through February 2014.

To assess the adequacy of OCC's supervision of First National, 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

[14] 12 U.S.C. § 1831o(k).

correct the problems. We also assessed whether OCC (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we performed the following work:

- We determined that the period covered by our audit would be from February 2007, through the bank's failure on September 13, 2013. This period included quarterly monitoring, six full-scope safety and soundness examinations, and three limited-scope examinations of First National by OCC.

- We reviewed OCC's supervisory files and records for the bank from 2007 through 2013. 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 First National documents that had been taken by FDIC and inventoried by FDIC 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.[15]

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.

[15] 12 U.S.C. § 1811 et seq.

First National Bank History

First National Bank (First National), Edinburg, Texas was a full-service national bank with trust powers that was established in 1934. First National was wholly-owned by its holding company, First National Bank Group, Inc. The bank's headquarters and the majority of its 52 branches were located in the McAllen-Edinburg-Mission, Texas, metropolitan area, which borders Mexico at the southernmost part of Texas and for the past decade, has been one of the fastest growing metropolitan areas in the nation.

First National pursued a growth strategy that commenced in 2001, funded primarily by non-core deposits. This strategy permitted significant concentrations in commercial real estate loans and construction and development loan portfolios, in the bank's local market areas, without commensurate risk management practices or adequate capital to protect the bank from a prolonged period of deteriorating asset quality. In 2001 alone, First National's total assets doubled from approximately $600 million to $1.2 billion. Thereafter, the bank's total assets increased approximately 22 percent per year, peaking in mid-2008 at approximately $4.6 billion. The bank also reached its' peak in the number of branches, at 64, in December 2009. At the date of failure on September 13, 2013, First National had $3.1 billion in total assets and 52 branches.

OCC Assessments Paid by First National Bank

OCC funds its operations in part through semiannual assessments on national banks. OCC publishes annual fee schedules, which include general assessments to be paid by each institution based on the institution's total assets. If the institution is a problem bank (i.e., it has a CAMELS composite rating of 3, 4, or 5), OCC also applies a surcharge to the institution's assessment to cover additional supervisory costs. These surcharges are calculated by multiplying the sum of the general assessment by 50 percent for 3-rated institutions or by 100 percent for 4- and 5-rated institutions. Table 2 shows the amounts that First National paid from 2007 through 2013.

Table 2: Assessments Paid by First National to OCC, 2007—2013

Billing Period	Exam Rating	Amount Paid
1/1/2007-6/30/2007	2	$324,364
7/1/2007-12/31/2007	2	334,524
1/1/2008-6/30/2008	2	350,803
7/1/2008-12/31/2008	3	367,272
1/1/2009-6/30/2009	3	345,796
7/1/2009-12/31/2009	3	478,838
1/1/2010-6/30/2010	3	489,912
7/1/2010-12/31/2010	4	495,026
1/1/2011-6/30/2011	4	491,372
7/1/2011-12/31/2011	5	641,726
1/1/2012-6/30/2012	5	622,892
7/1/2012-12/31/2012	5	620,462
1/1/2013-6/30/2013	5	599,014

Source: OCC.

Number of OCC Staff Hours Spent Examining First National

Table 3 shows the number of OCC staff hours spent examining First National from 2007 to 2013.

Table 3: Number of OCC Hours Spent Examining First National, 2007-2013

Examination Start Date	Number of Examination Hours
9/10/2007	1,436
9/1/2008	1,556
8/17/2009	319
8/16/2010	2,612
8/1/2011	4,751
8/13/2012	3,000
8/1/2013	500

Office of the Comptroller of the Currency

Washington, DC 20219

April 14, 2014

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 First National Bank, Edinburg, Texas (First National)." This review is mandated by section 38(k) of the Federal Deposit Insurance Act because of the magnitude of the bank's estimated loss to the Deposit Insurance Fund. Your objectives were to determine the causes of First National'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 the supervisory files and interviewed OCC and Federal Deposit Insurance Corporation officials.

You concluded that the primary causes of First National's failure were aggressive growth resulting in a high-risk concentration of commercial real estate loans and undue influence by the former chairman of the board and deficient senior management oversight and governance.

You also concluded that OCC examiners generally followed guidance in supervising First National and OCC's use of PCA was appropriate. However, OCC (1) did not identify First National's potentially improper accounting of 2009 capital injections until 2013; (2) did not timely identify improper accounting for interest income on nonaccrual loans using the cash-basis method; and (3) closed a Matter Requiring Attention in 2010 without sufficient evidence.

You make two recommendations not addressed in earlier material loss reviews. First, you recommend that the OCC remind examiners to follow OCC guidance in the "Capital Accounts and Dividends" booklet regarding the documentation of material changes in a bank's capital accounts and *Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution* booklet regarding watching for aggressive accounting positions taken by management. As part of our ongoing discussions of lessons learned with our managers, we will share this finding and direct them to ensure that material changes in a bank's capital account are properly documented.

We will also discuss this topic during our next nationwide call with all of the midsize and community bank examiners.

Second, you recommend that OCC expand examiner guidance in the "Loan Portfolio Management" booklet to provide instructions regarding the proper accounting treatment for nonaccrual loans, including the accounting for payments received on these loans. An update of the "Loan Portfolio Management" booklet is scheduled to begin later this year with publication in early 2015. We note, however, that relevant guidance on this topic can also be found in the OCC's "Rating Credit Risk" booklet, the Federal Financial Institutions Examination Council's *Call Report Instructions*, and the OCC's *Bank Accounting Advisory Series* (BAAS). The BAAS is updated annually and the most recent update included an expanded discussion of how to treat cash payments for nonaccrual loans.

If you need additional information, please contact me or Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, at 202-649-5420.

Sincerely,

/s/

Thomas J. Curry
Comptroller of the Currency

Theresa Cameron, Audit Manager
April Ellison, Auditor-in-Charge
Clyburn Perry III, Program Analyst
Fawntrella Thompson, 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

Comptroller of the Currency
Liaison Officer

Office of Management and Budget

OIG Budget Examiner

U.S. Senate

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

Chairman and Ranking Member
Committee on Finance

U.S. House of Representatives

Chairman and Ranking Member
Committee on Financial Services

Federal Deposit Insurance Corporation

Chairman
Acting Inspector General

U.S. Government Accountability Office

Comptroller General of the United States