Audit Report

OIG-10-038

SAFETY AND SOUNDNESS: Material Loss Review of Citizens National Bank

March 22, 2010

Office of Inspector General

Department of the Treasury

Contents

Abbreviations

ALLL	allowance for loan and lease losses
ANB	ANB Financial, National Association
CCB	Citizens Central Bancorp
CEO	chief executive officer
CMO	collateralized mortgage obligation
CNB	Citizens National Bank

COB	chairman of the board
CRE	commercial real estate
CRP	capital restoration plan
FDIC	Federal Deposit Insurance Corporation
IT	information technology
MRA	matter requiring attention
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
PCA	prompt corrective action
ROE	report of examination
SCB	Strategic Capital Bank

OIG

Audit Report

The Department of the Treasury
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March 22, 2010

John C. Dugan
Comptroller of the Currency

This report presents the results of our material loss review of the failure of Citizens National Bank (CNB), of Macomb, Illinois, and of the Office of the Comptroller of the Currency's (OCC) supervision of the institution. OCC closed CNB and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on May 22, 2009.[1] Section 38(k) of the Federal Deposit Insurance Act mandated this review because of the magnitude of CNB's estimated loss to the Deposit Insurance Fund.[2] As of January 29, 2010, FDIC estimated that the loss would be $26 million.[3]

Our objectives were to determine the causes of CNB'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 such a loss in the future. To accomplish these objectives, we reviewed the supervisory files and interviewed OCC and FDIC officials, conducting fieldwork from August through November 2009. Appendix 1 contains a more detailed description of our material loss review objectives, scope, and methodology.

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[1] The Chief Executive Officer (CEO)/Chairman of the Board (COB) of CNB owned 40 percent of the stock in the holding company for CNB. The CEO/COB also held 40 percent of the stock in the single-bank holding company for Strategic Capital Bank (SCB), an FDIC-supervised institution. Both CNB and SCB failed on the same day. The FDIC Office of Inspector General (OIG) conducted a material loss review of SCB and issued its report on December 4, 2009 (FDIC OIG, *Material Loss Review of Strategic Capital Bank, Champaign, Illinois*, Report No. MLR-10-007). The loss estimate for SCB reported by FDIC OIG was $172.3 million. FDIC subsequently revised the loss estimate to $212 million as of January 29, 2010.
[2] Section 38(k) defines a loss as material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.
[3] The original loss estimate was $102.9 million. As of December 31, 2009, FDIC decreased this amount to $26 million based on revised estimated recoveries.

We also include several other appendices to this report. Appendix 2 contains background information on CNB's history and OCC's supervision processes. Appendix 3 is a glossary of terms used in this report. These terms are underlined and, in the electronic version of the report on our Web site, hyperlinked to the glossary. Appendix 4 contains a chronology of significant events related to CNB's history and OCC's supervision of the institution. Appendix 5 shows examinations of CNB by OCC from 2005 to 2009 and the enforcement action taken by OCC against CNB. Appendix 6 shows Treasury Office of Inspector General recommendations from material loss reviews of failed OCC-regulated institutions completed since November 2008.

Results in Brief

CNB failed because management undertook a high-risk strategy of investing heavily in private-label collateralized mortgage obligations (CMOs) and commercial real estate (CRE) loan participations. These assets were funded principally with brokered deposits. This strategy led to a rapid growth and high concentrations in CMOs and CRE loan participations. CNB's management and board did not establish adequate controls commensurate with the risks associated with these assets. In addition, management purchased subprime automobile loans without properly reviewing the loan applications underwritten by a third party. Significant portions of the CMOs, CRE loan participations, and subprime automobile loans subsequently defaulted and were written off, causing the bank to become undercapitalized. There were certain transactions related to the bank that are under further OCC review.

We believe that OCC could not have done anything significantly different to prevent CNB's failure and the material loss to the Deposit Insurance Fund. OCC examiners detected increases in CNB's investment portfolio and changes in the bank's investment strategy as reflected in the fourth quarter 2007 and first quarter 2008 call reports. In July 2008 OCC conducted a targeted examination of CREs that it considered to be of higher risk. OCC expanded the scope of its targeted examination to review the bank's downgraded CMO holdings and in November 2008 conducted a complete review of the bank's CMO investments, including its risk management practices and the risk assessments of the CMOs.

OCC had extensive internal discussions and worked with other supervisory agencies to provide proper guidance to the bank on risk-weighting of the downgraded CMOs. Subsequently, OCC issued additional guidance for risk management of structured investment securities. OCC also took appropriate actions required by PCA as CNB's capital levels fell.

As a regulatory matter, current law and regulatory standards permit banks to purchase investment grade CMOs without any statutory limitation.[4] Given the experience with the National Bank of Commerce, which failed due to significant losses from preferred stock holdings in the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation[5] and more recently CNB, we believe that circumstances and conditions point to a potentially vulnerable regulatory area.

We are recommending that OCC (1) assess the adequacy of its recently issued guidance on investment securities after it has been in use for a reasonable time and (2) work with its regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for bank investments.

In a written response, OCC agreed that it is important to have an ongoing process to assess the adequacy of its bank supervision policies. In this regard, its policy experts respond to questions from bankers and examiners regarding the application of policies. The interaction enables them to recognize situations where clarifications or additional guidance are needed. Also, OCC stated that it is too early to say whether the final outcome of the deliberations with its regulatory partners will include changes in bank investment limits or risk management expectations. It will continue to study the situation and interface with its regulatory

[4] 12 U.S.C. § 24 (Seventh). OCC issued implementing guidance in 12 C.F.R. Part 1, Investment Securities.
[5] *Safety and Soundness: Material Loss Review of National Bank of Commerce*, OIG-09-042 (Aug. 6, 2009).

partners when appropriate. OCC's response is provided as appendix 7.

We consider the actions taken and planned by OCC as responsive to the recommendations. We plan to evaluate OCC's process for updating guidance in the future. We will also monitor the progress of the interagency deliberations with respect to bank investment limits or risk management expectations as part of our future planned work.

Causes of CNB's Failure

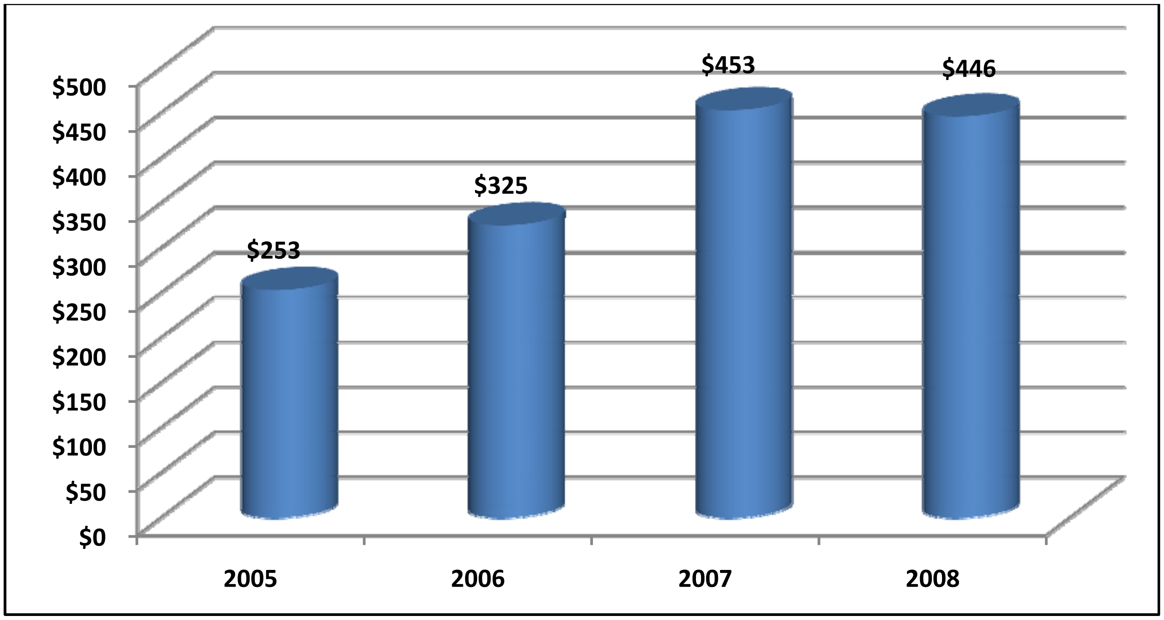
CNB failed because management pursued an aggressive growth strategy concentrated in high-risk private-label CMOs[6] and CRE loan participations, which were funded principally with brokered deposits. CNB management also purchased and experienced losses on subprime automobile loans underwritten by a third party without properly reviewing the loans. CNB's board did not ensure that bank management identified, measured, monitored, and controlled the high risks associated with CNB's assets.

Rapid Growth and High Concentrations

CNB's assets grew rapidly after a change of ownership in January 2006. As figure 1 shows, from the end of 2005 to the end of 2008, CNB's total assets increased from $253 million to $446 million, or 76 percent. The asset growth was funded by brokered deposits, which increased from $31 million to $192 million during the same period. This increase resulted in CNB holding less capital in relation to the assets it owned. Growth in CNB's assets was most pronounced from 2006 to 2007; over that period, the bank's assets increased by 39 percent. From 2007 to 2008, however, total assets decreased from $453 million to $446 million due to write-downs of some assets.

[6] There are two kinds of CMOs—agency CMOs and private-label CMOs. Agency CMOs carry the guarantee of a government or a government-sponsored enterprise, such as the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation. Private-label CMOs do not carry such guarantees.

Figure 1. CNB Asset Growth, Calendar Years 2005-2008 (in millions)

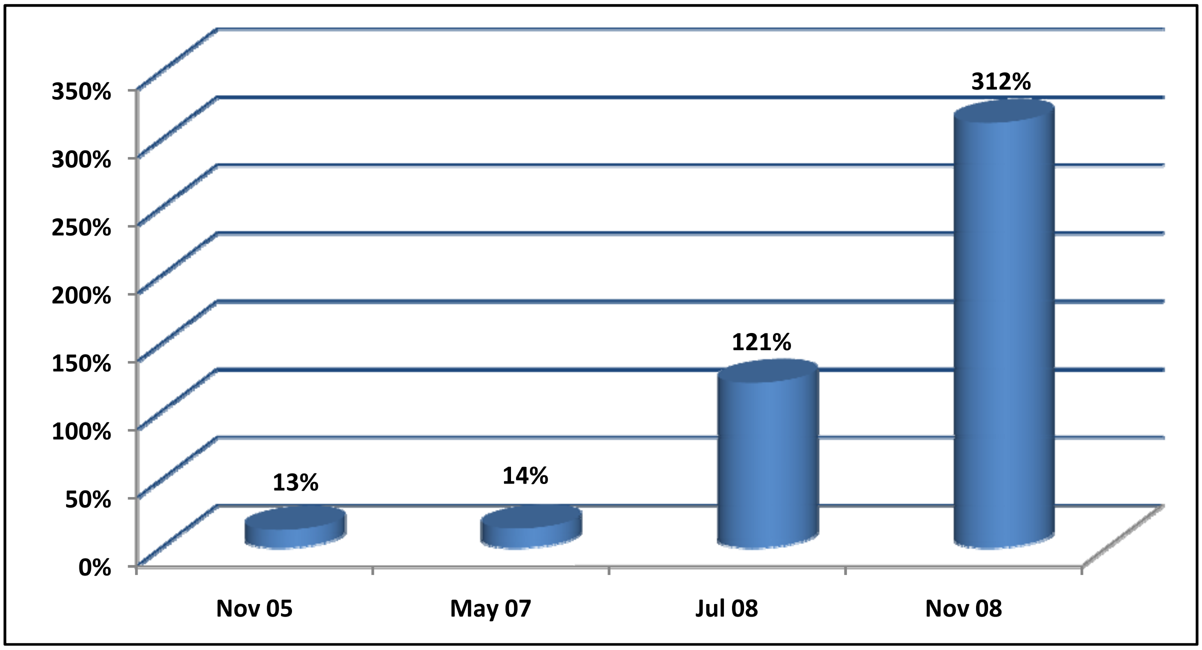


Source: CNB call reports.

The rapid growth in CNB's assets was accompanied by high concentrations in a few types of assets, particularly private-label CMOs and CRE loan participations. CMOs represented approximately 192 percent of the bank's Tier 1 capital plus allowance for loan and lease losses (ALLL) as of September 30, 2008. Total CRE loans represented approximately 432 percent of the bank's Tier 1 capital plus ALLL as of that date.

The rapid growth in highly concentrated assets resulted in elevated risk. As economic conditions worsened, asset quality deteriorated as evidenced by a high level of adversely classified assets. As shown in figure 2, total adversely classified assets as a percentage of Tier 1 capital plus ALLL rose from 13 percent in November 2005, just 2 months before the bank changed ownership, to 312 percent by November 2008. CMOs accounted for more than half of the $70.5 million in adversely classified assets.

Figure 2. Adversely Classified Assets as Percentage of Tier 1 Capital Plus ALLL



Source: OCC ROEs.

Eventually, rapid growth and high concentrations in assets vulnerable to economic downturn resulted in significant losses to CNB and led to its failure. From its private-label CMO investments, CNB lost $20.5 million in the second half of 2008 and the first quarter of 2009 due to their reduced value. CNB also lost $2.2 million in 2008 from its CRE loan participations.

Risky Management Practices

OCC defines a concentration of credit as direct, indirect, or contingent obligations collectively exceeding 25 percent of the bank's capital structure (Tier 1 risk-based capital plus the ALLL).[7] Concentrations pose additional risk because the same economic, political, or environmental event can negatively affect the entire group of assets or liabilities. According to OCC, a bank is potentially exposed to elevated commercial credit risk if total CRE loans represent over 300 percent of total capital and the balance of

[7] OCC Comptroller's Handbook, Concentration of Credits (March 1990).

the portfolio has increased more than 50 percent in the prior 36 months.[8]

The concentrations in private-label CMOs and CRE loans posed significant risks but CNB's board and management did not implement internal systems to control the risks. During back to back examinations, OCC examiners found that the bank's risk management practices were not commensurate with the level of risk related to its significant concentrations in CMOs (2008 exam) and CRE loans (2007 exam).

Investments in Private-Label CMOs

In early 2007, before purchasing private-label CMOs, CNB's investment portfolio was concentrated in good quality and relatively safe municipal bonds and government and agency issues. CNB purchased $66 million in the CMOs during the 6-month period ending March 31, 2008. At the time of purchase, the CMOs were rated investment grade. However, in May 2008, two of the CMO holdings were downgraded below investment grade and began declining in value.

The decision to purchase the private-label CMOs in such a short period of time was made by the bank's senior management. According to board meeting minutes, CNB's board members did not question or object to management's decision. The investments were funded by a significantly increased volume of brokered deposits, which went from $31 million to $192 million, a 600 percent increase, from the end of 2005 to the end of 2008. The original purpose of this increase in brokered deposits was to purchase long-term municipal bonds but was expanded to fund the purchase of the CMOs.

In May 2007, while the bank focused on investing in municipal bonds and had not yet expanded the investment portfolio to private-label CMOs, OCC reviewed CNB's security investment strategy and raised a number of concerns with risk management. Some of the concerns—in particular, weak interest rate and

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

liquidity risk management—later became more critical when management purchased the CMOs.

OCC Bulletin 98-20 outlines supervisory expectations for risk management practices that financial institutions should establish and maintain to manage the market, credit, liquidity, legal, operational, and other risks of investment securities. It states that:

> "the agencies expect institutions to understand the price sensitivity of securities before purchase (pre-purchase analysis) and on an ongoing basis. In addition, to properly assess exposure to interest rate risk, institutions should understand the price sensitivity of the aggregate investment portfolio."[9]

OCC Bulletin 2002-19 further emphasizes the need to have an appropriate risk management framework for the level of risk taken in the investment portfolio, to supplement credit ratings with internal credit analysis, and for bank management to demonstrate an understanding of the structure of the security.[10] CNB's management and board failed to establish a risk management framework that addressed these needs. Also, they did not adhere to the comprehensive risk management practices that the guidance outlined.

After CNB purchased the private-label CMOs, OCC issued further guidance regarding risks involved and additional actions that were needed. According to OCC guidelines, the risks associated with CMOs include credit, liquidity, price, and interest rate risks, and banks should establish security investment policies and risk management guidelines that address these risks effectively and comprehensively. In addition, banks with significant exposure to concentrations of credit, or those not adequately managing concentration risks, may require capital in excess of regulatory minimums.[11]

As previously noted, CNB management purchased a large amount of private-label CMOs within a short time. Although the CMOs

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[9] OCC Bulletin 98-20, Investment Securities (April 27, 1998).
[10] OCC Bulletin 2002-19, Unsafe and Unsound Investment Portfolio Practices (May 22, 2002).
[11] OCC Bulletin 2009-15, Investment Securities (May 22, 2009).

were rated either AAA or AA when CNB purchased them, two of the bonds, which represented about 31 percent of the total CMOs the bank owned, were subsequently downgraded to CCC when a rating company reassessed the risks based on certain mortgage collateral components that became noncurrent.

CRE loan participations

When concentrations in CRE or other real estate exist, sound credit risk management systems and maintenance of appropriate capital levels are critical. An appropriate credit risk management system in such circumstances would include strong underwriting standards and policies and procedures to monitor and manage inherent risks. Although OCC Bulletin 2006-46 does not provide quantifiable limits on banks' CRE lending, it does describe risk management practices that allow an institution to pursue CRE lending in a safe and sound manner. According to guidance, institutions should address the following key elements in establishing a risk management framework that effectively identifies, monitors, and controls CRE concentration risk:

- board and management oversight
- portfolio management
- management information systems
- market analysis
- credit underwriting standards
- portfolio stress testing and sensitivity analysis
- credit risk review function

In addition, according to OCC Comptroller's Handbook, Loan Portfolio Management, satisfactory controls over the purchase of loans and participations in loans ordinarily include the following:

- sound policies and procedures governing these transactions
- an independent analysis of credit quality by the purchasing bank
- agreement by the obligor to make full credit information available to the selling bank
- agreement by the selling bank to provide available information on the obligor to the purchaser

- written documentation of recourse arrangements outlining the rights and obligations of each party.[12]

CNB management purchased $22 million in CRE loan participations between July 2006 and December 2007. The loans were originated by ANB Financial, National Association (ANB), which was placed into receivership on May 9, 2008. In our report on the material loss review of ANB's failure, we stated that

> "[b]y 2006, the combination of CRE loan concentrations, the softening of the residential real estate market, and weaknesses in ANB's credit risk management practices resulted in deterioration of ANB's asset quality and an increase in the volume of adversely classified and criticized assets."[13]

OCC examiners repeatedly raised their concerns to CNB about the bank's deficient risk management. During the 2007 full-scope examination, examiners found CNB's CRE loan risk management practices to be deficient and included the deficiency as a matter requiring attention (MRA) in the report of examination (ROE). During the July 2008 targeted examination, examiners found that the CRE loan credit risk had increased. They also found that CNB's board and management had not addressed MRAs raised during the 2007 full-scope examination. The examiners re-emphasized the importance of addressing these outstanding MRAs and made additional recommendations concerning management of the CRE loan credit risk.

Subprime automobile loans

CNB also purchased 179 subprime automobile loans totaling approximately $3.4 million within a very short period, from November 2007 to February 2008. The credit underwriting was primarily performed by a third party and agreed to by CNB. Among the 179 loans, only 3 were fully paid, 50 loans went into default on their first payment or were charged off, and the remaining were

[12] OCC Comptroller's Handbook, Loan Portfolio Management (April 1998).
[13] *Safety and Soundness: Material Loss Review of ANB Financial, National Association*, OIG-09-013 (Nov. 25, 2008).

adversely classified. OCC examiners were particularly critical about the purchases as a reckless action.

<u>Risk-weighting of CMOs</u>

For risk-weighting of structured investment securities, such as private-label CMOs, existing regulatory requirements direct banks to assign risk-weights to the securities based on external credit ratings or, alternately, based on an analysis of the obligor or underlying collateral.[14] During the second quarter of 2008, the credit rating of two of the CMOs held by CNB was reduced to CCC, a sub-investment grade, considerably increasing the risk-weight for the downgraded securities in calculating risk-based capital ratios pursuant to 12 C.F.R. Part 3.[15] In connection with its filing of the call report for June 30, 2008, CNB requested on July 25, 2008, that, among other risk-based capital treatments, OCC allow a risk-weight of 20 percent for the downgraded securities. In this regard, the CEO/COB of CNB, who was also the CEO/COB of SCB, had already been notified by FDIC on July 17, 2008, that SCB should assign the downgraded CMOs a 100 percent risk-weight, requiring SCB to maintain additional capital. As discussed later in this report, OCC initially responded to CNB's request by allowing a 50 percent risk-weighting but later determined that a 100 percent risk-weighting was appropriate, consistent with FDIC's guidance to SCB. We believe that CNB's request of OCC for a lower risk-rating than that already directed by FDIC for the affiliated bank only served to delay the proper financial regulatory reporting of its true financial condition.

In summary, board and management did not establish adequate controls to manage the risks associated with CMOs and CRE loan participations. Significant portions of these assets subsequently defaulted and were written off, causing the bank to become undercapitalized. OCC closed the bank on May 22, 2009, and appointed FDIC as receiver.

[14] *Section 4 of* 12 C.F.R. Part 3, Appendix A, as amended July 1, 2002, Recourse, Direct Credit Substitutes and Positions in Securitizations.
[15] A bank's total risk-based capital ratio is calculated by dividing the capital base – sum of tier 1 and tier 2 capital – by <u>risk-weighted assets</u>. Risk-weighted assets include balance sheet assets and off-balance sheet items in proportion to their relative credit risk. The net effect of risk-weighting is that banks must hold more capital to absorb potential losses as risks associated with its assets increase.

OCC's Supervision of CNB

We believe that OCC could not have done anything significantly different to prevent CNB's failure and the material loss to the Deposit Insurance Fund. OCC examiners detected increases in CNB's investment portfolio when the bank decided to shift its investment strategy to purchase CMOs. In determining the proper risk-weighting, OCC deliberated with other supervisory agencies to provide proper guidance to the bank on risk-weighting of the downgraded CMOs. Subsequently, OCC issued additional guidance for risk management of structured investment securities. OCC also took the required PCA actions as CNB's capital levels fell.

Table 1 lists OCC's examinations of CNB conducted from November 2005 to November 2008.[16] Appendix 5 provides additional details of these examinations, including MRAs and other recommendations made by OCC.

Table 1. OCC Examinations of CNB, November 2005-November 2008

		Examination Results			
Date started Type of examination	**Assets (millions)**	**CAMELS rating**	**Number of MRAs**	**Number of recommendations**	**Formal enforcement action**
11/3/2005 **(full-scope examination)**	$230	1/111212	0	2	None
5/21/2007 **(full-scope examination)**	$329	1/121212	5	6	None
7/7/2008 **(targeted examination)**	$461	3/342232	4	3	None
11/3/2008 **(full-scope examination)**	$452	5/555533	3	0	PCA directive issued 4/22/2009

Source: OCC ROEs and PCA directive.

[16] OCC conducted its examinations of CNB in accordance with the timeframes prescribed by OCC policy.

OCC Detected Changes in CNB's Investment Portfolio

As already mentioned, CNB purchased $66 million of the private-label CMOs during the fourth quarter 2007 and first quarter 2008. During periodic monitoring activities, OCC examiners noted the increases in CNB's investment portfolio and the change in the bank's investment strategy through its reviews of the call reports for those periods. According to the examiners, the CMO purchases did not prompt concern on their part at the time because the CMOs were highly rated, investment grade securities.

Two of these CMOs became sub-investment grade in May 2008. OCC examiners became aware of the downgrade in late July 2008, about 2 months later, when informed of the downgrade by CNB's CEO/COB. Although the examiners may have discovered the downgrade sooner by reviewing such things as CNB's board minutes, we concluded that this would not have significantly affected the supervisory response. During our audit, we discussed with OCC officials whether monitoring activities between examinations should include reviews of board minutes as they can provide early indications of changes in a bank's strategy and risk profile. According to OCC, to do so would require examiners to obtain voluminous documents from banks and the review of the documents would be resource intensive, detract from other activities, and is contrary to OCC's risk-based supervisory approach. We accept in the case of CNB that such reviews of board minutes would not have made a significant difference, but this is an area we plan to explore further in future work.

In July 2008, OCC conducted a targeted examination of CNB's CRE loan participations. During the targeted examination, the examiners became aware of the issues associated with the CMOs and expanded the scope of the examination. The CMOs were reviewed by an OCC capital markets expert and Headquarters policy staff during the targeted exam, and, as indicated earlier in this report, there was extensive communication between OCC and the bank regarding the quality of the CMOs and their risk-weights. OCC conducted a more comprehensive review of the bank's risk management practices with respect to CMO purchases during the November 2008 full-scope examination.

OCC Issued New Guidance on Investment Securities

As discussed earlier, in late July 2008, CNB sought OCC's permission to use a lower risk-weight (20 percent) than indicated in existing guidance for two of its private-label CMOs after they were downgraded to below investment grade during the second quarter of 2008. The request was critical for the bank because more of its CMOs were subsequently downgraded after the second quarter of 2008. OCC's Peoria field office requested guidance from OCC's capital markets specialists in the district office and Headquarters. Initially, the capital markets specialists informed the field office that the bank should apply a 50 percent, rather than the 20 percent, risk-weight sought by the bank.

CNB reported its capital position as well capitalized in its second quarter 2008 call report. In that call report, CNB used 20 percent as the risk-weight for the CMOs. Immediately after the filing, in late July 2008, OCC's Peoria field office directed the bank to refile the call report subjecting the full amount of the CMOs to a 50 percent risk-weight. As a result, the bank's capital position was reported as undercapitalized when the call report was refiled on August 5, 2008. Subsequently, CNB's holding company infused $1 million into the bank to increase capital.

Discussion about the appropriate risk-weighting continued among OCC, FDIC, and Federal Reserve capital markets specialists into September 2008 when it was then concluded that the bank should assign a 100 percent risk-weight for CMO holdings with non-performing mortgages and a 50 percent risk-weight for CMO holdings with performing mortgages. CNB applied the guidance to its third quarter 2008 call report filing and reported its capital position as undercapitalized for that quarter as well. (OCC did not direct the bank to revise its second quarter 2008 call report based on the new guidance).

The deliberation among the capital markets specialists also resulted in more definitive guidance being issued regarding risk-based capital treatment. The OCC capital markets specialist we interviewed told us that the existing regulatory guidelines had been established without envisioning that banks would purchase structured investment securities, and regulatory guidelines were complex to interpret. After the interagency discussions on the issue, OCC issued a bulletin in May 2009 to provide guidance for banks on risk management concerning structured investment securities.[17] If the guidance is properly followed, it should result in better risk management of investment securities. However, because this is a complex area, we believe it would be prudent for OCC to assess the adequacy of the guidance.

OCC Appropriately Used Prompt Corrective Action

The purpose of PCA is to resolve problems on 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 to certain levels. PCA also gives regulators flexibility to discipline institutions based on criteria other than capital levels to help reduce deposit insurance losses caused by unsafe and unsound practices.

Based on the supervisory actions, we concluded OCC implemented applicable PCA provisions, as follows:

- In a letter dated August 28, 2008, OCC notified CNB that its total risk-based capital ratio caused it to be in the adequately capitalized category for PCA purposes, based on CNB's balance sheet as of August 5, 2008 (after the $1 million capital infusion discussed earlier). OCC's notice appropriately informed CNB that the adequately capitalized category prohibited it from accepting or renewing brokered deposits without a waiver from the FDIC and restricted the effective yield on deposits.

- On November 3, 2008, based on the September 30, 2008 call report, OCC notified CNB of its undercapitalized category and directed it to submit a capital restoration plan (CRP) to OCC by December 15, 2008. OCC informed CNB that an acceptable CRP must satisfactorily address the steps the bank would take to achieve and maintain capital levels to meet the adequately capitalized category pursuant to PCA; the types and levels of activities in which CNB would

[17] See footnote 11.

engage; and how CNB would comply with PCA's restrictions against asset growth, acquisitions, branching, and new lines of business. OCC notified CNB that failure to submit an acceptable CRP by December 15, 2008, would cause the bank to be significantly undercapitalized for PCA purposes. Also, OCC informed CNB that regulations prohibited the bank from accepting or renewing brokered deposits and restricted the effective yield on insured deposits.

On January 26, 2009, OCC notified CNB that its CRP was unacceptable due to its dependence on receiving assistance from Treasury to restore capital.[18]

- On February 5, 2009, OCC notified CNB of its significantly undercapitalized category based on the December 31, 2008, call report, and again directed CNB to submit an acceptable CPR by March 2, 2009. OCC informed the bank that it was subject to restrictions regarding capital distributions, management fees, asset growth, acquisitions, branching, new lines of business, and senior executive officers' compensation pursuant to PCA. CNB's PCA status also prohibited it from accepting employee benefit plan deposits. OCC reminded the bank of the requirements for an acceptable CRP, including Citizens Central Bancorp's guarantee that CNB would comply with the plan, guarantee of liability for 5 percent of CNB's assets, and appropriate assurances of performance.

- On March 20, 2009, OCC notified CNB of its intention to issue a PCA Directive, based on the report of examination as of September 30, 2008. The letter stated that the bank was significantly undercapitalized for PCA purposes and had failed to submit an acceptable CRP.

[18] On November 14, 2008, Citizens Central Bancorp, CNB's holding company, applied to OCC for financial assistance under the Department of the Treasury's Capital Purchase Program. The Capital Purchase Program was implemented by Treasury using its Troubled Asset Relief Program authorities granted by the Emergency Economic Stabilization Act of 2008. On November 18, 2008, given the bank's troubled condition, OCC did not recommend approval of CCB's request to Treasury.

- On March 30, 2009, CNB informed OCC that it was unable to submit an acceptable CRP because it had no prospects for obtaining the significant amount of capital that it needed.

- On April 22, 2009, OCC issued a PCA Directive to CNB. The PCA Directive required the bank to become adequately capitalized for PCA purposes by June 30, 2009, through the sale of shares or obligations; a merger or acquisition; or the sale of all or substantially all of its assets and liabilities. The PCA Directive informed CNB that it was subject to the mandatory restrictions for significantly undercapitalized banks set forth in 12 U.S.C. § 1830o and 12 C.F.R. Part 6.

It should be noted that had the bank properly risk-weighted the CMOs in its initial call report filings in late July 2008, its capital levels would have been reported as less than well-capitalized earlier and certain PCA limitations would have applied to the bank 3 months sooner. When the bank's financial condition was reported as deteriorating below required capital levels, OCC took the appropriate enforcement action addressing CNB's capital deficiency in accordance with PCA capital-related provisions. When CNB was unsuccessful in raising the needed capital, OCC closed it on May 22, 2009.

OCC Lessons-Learned Review

According to OCC headquarters officials, OCC had not begun an internal lessons-learned review of the failure of CNB. The purpose of the lessons-learned review is to assess the causes of the failure and OCC's supervision of the bank.

Other Regulatory Matter

<u>Investment Securities Limitation</u>

Current law and regulatory standards permit banks to purchase investment grade CMOs without any statutory limitation.[19] Given the experience with the National Bank of Commerce, which failed due to significant losses from preferred stock holdings in the

[19] U.S.C. 24 (Seventh). OCC issued implementing guidance in 12 C.F.R. Part 1, Investment Securities.

Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation and more recently CNB, we believe that circumstances and conditions described in this report point to a potentially vulnerable regulatory area.

Recommendations

Our material loss review of CNB is the eighth such review we have performed of a failed OCC-regulated financial institution during the current financial crisis. Appendix 6 lists the other seven material loss reviews and our associated recommendations. With one exception noted in the appendix, OCC management agreed with the prior recommendations and has taken or is taking corrective actions to address them.

As a result of our material loss review of CNB, we recommend that the Comptroller of the Currency do the following:

1. Due to the complexity of the risk-based capital treatment of structured investment securities, assess the adequacy of OCC Bulletin 2009-15, Investment Securities, after it has been in use for a reasonable time.

   Management Response

   OCC agreed that it is important to have an ongoing process to assess the adequacy of its bank supervision policies. OCC stated that its policy experts respond to questions from bankers and examiners regarding the application of policies, such as Bulletin 2009-15, and recognize situations where clarifications or additional guidance are needed.

   OIG Comment

   We understand that OCC has an ongoing process to assess its bank supervision policies and, as with the case of OCC Bulletin 2009-15, the guidance was updated in response to questions from bankers and examiners. To the extent this revised bulletin is subjected to periodic assessment, the intent of our recommendation is met. We plan to evaluate OCC's process for updating guidance in the future.

2. Work with OCC's regulatory partners to determine whether to propose appropriate legislation and/or change regulatory guidance to establish limits or other controls for bank investments.

   Management Response

   OCC works with other regulators to develop guidance on a variety of subjects where common issues or concerns exist. The Federal Financial Institutions Examination Council[20] and other interagency forums are evaluating a number of factors that contributed to the current problems in the banking industry and will consider what regulatory changes are needed. At this point, it is too early to say whether the final outcome of those deliberations will include changes in bank investment limits or risk management expectations, but we will continue to study the situation and interface with our regulatory partners when appropriate.

   OIG Comment

   Although OCC did not include a timeframe for the interagency deliberations and any actions resulting from those deliberations, we believe OCC's response meets the intent of our recommendations. We plan to monitor progress in this area in the future.

[20] The Federal Financial Institutions Examination Council was established in 1979 pursuant to the Financial Institutions Regulatory and Interest Rate Control Act of 1978. The Council is a formal interagency body empowered 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, FDIC, the National Credit Union Administration, OCC, and the Office of Thrift Supervision.

* * * * *

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) 927-6512 or Delores V. Dabney, Audit Manager, at (202) 927-5941. Major contributors to this report are listed in appendix 8.

/s/
Michael J. Maloney
Audit Director

We conducted this material loss review of Citizens National Bank (CNB), Macomb, Illinois, in response to our mandate under section 38(k) of the Federal Deposit Insurance Act.[21] This section provides that if a 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, which shall

- ascertain why the institution's problems resulted in a material loss to the insurance fund;
- review the agency's supervision of the institution, including its implementation of the prompt corrective action provisions of section 38; and
- make recommendations for preventing any such loss in the future.

Section 38(k) defines a loss as material if it exceeds the greater of $25 million or 2 percent of the institution's total assets. 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.

To accomplish our review, we conducted fieldwork at the Office of the Comptroller of the Currency's (OCC) headquarters in Washington, D.C., its field office in Peoria, Illinois, and CNB's main office in Macomb, Illinois. We interviewed officials of the Federal Deposit Insurance Corporation's (FDIC) Division of Supervision and Consumer Protection and Division of Resolutions and Receiverships. We conducted our fieldwork from August through November 2009.

To assess the adequacy of OCC's supervision of CNB, we determined (1) when OCC first identified CNB'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 determined whether OCC (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective

[21] 12 U.S.C. § 1831o(k).

enforcement actions that dealt with any unsafe or unsound activities. Specifically, we performed the following work:

- We determined that the time period covered by our audit would begin with the 2005 examination and end with CNB's failure on May 22, 2009. This period included two safety and soundness examinations prior to OCC's identifying CNB as a troubled institution and assigning it a composite CAMELS rating of 5.

- We reviewed OCC supervisory files and records for CNB from November 2005 through May 2009. We analyzed examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OCC used to assess the bank's condition, and the regulatory action OCC used to compel bank management to address deficient conditions. 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 of CNB with OCC officials and an examiner in charge to obtain their perspective on the bank's condition, the scope of the examinations, and supervisory steps taken. We also interviewed FDIC Division of Supervision and Consumer Protection personnel who were responsible for monitoring CNB for federal deposit insurance purposes.

- We interviewed FDIC Division of Resolutions and Receiverships personnel involved in the receivership process, which was conducted before and after CNB's closure and appointment of a receiver.

- We interviewed FDIC OIG personnel and reviewed the OIG's material loss review report on Strategic Capital Bank to gain an understanding of the issues surrounding the bank's failure and FDIC's supervision of the bank.

- We reviewed CNB records obtained by the FDIC Division of Resolutions and Receiverships and located at the bank in Macomb, Illinois.

- We assessed OCC's actions based on its internal guidance and the requirements of the Federal Deposit Insurance Act.[22]

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.

[22] 12 U.S.C. § 1811 *et seq.*

Citizens National Bank History

Citizens National Bank (CNB) was established as a state bank in 1890 and converted to a national bank charter in 1939. CNB was a community bank with trust powers. In addition to its main office, CNB had five branch offices and one loan production office in Illinois. Citizens Central Bancorp, Inc., a one-bank holding company, wholly owned CNB. Two individuals owned approximately 80 percent of the holding company.

Appendix 4 contains a chronology of significant events regarding CNB.

Types of Examinations Conducted by the Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency (OCC) conducts various types of bank examinations, including full-scope examinations. A full-scope examination is a combined examination of the institution's safety and soundness, compliance with various rules and regulations, and information technology (IT) systems. The safety and soundness portion of the examination includes a review and evaluation of capital adequacy, asset quality, management effectiveness, earnings performance, liquidity and asset/liability management, and sensitivity to market risk. The IT portion of the full-scope examination evaluates the overall performance of IT within the institution and the institution's ability to identify, measure, monitor, and control technology-related risks. The compliance portion of the examination includes an assessment of how well the bank manages compliance with various consumer protection regulations, such as Truth in Lending, Truth in Savings, and the Bank Secrecy Act. A targeted examination is any examination that does not fulfill all the statutory requirements of a full-scope examination.[23]

[23] 12 U.S.C. § 1820(d) generally requires that the appropriate federal banking agency conduct a full-scope, onsite examination of each insured depository institution at least once during each 12-month period. However, the 12-month period may be extended to 18 months depending on the size and other circumstances of the affected institution.

The results of full-scope examinations are used to assign ratings to banks.[24] OCC, like other bank regulatory agencies, uses the Uniform Financial Institutions Rating System, commonly called CAMELS ratings. A bank's composite rating under CAMELS integrates ratings from six component areas: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk.

OCC assigns each banking organization individual CAMELS component ratings and a composite rating that indicates the institution's overall condition. CAMELS composite and component ratings are on a five-point scale, with 1 being the best score and 5 being the worst.

Banks with a composite rating of 1 are sound in every respect, generally have components rated 1 or 2, and give no cause for supervisory concern. Banks with a composite rating of 2 are fundamentally sound, generally have no component rated 4 or 5, and exhibit no material supervisory concerns. Banks with a composite rating of 3 exhibit some degree of supervisory concern in one or more component areas, generally have no component with a rating of 5, and require more than normal supervision, which may include formal or informal enforcement actions. Banks with a composite rating of 4 exhibit unsafe and unsound practices and have problems ranging from severe to critically deficient that are not being satisfactorily addressed by management. Banks with a composite rating of 5 exhibit extremely unsafe and unsound practices or conditions, have critically deficient performance, and present the greatest supervisory concern.

Types of Enforcement Actions Available to OCC

OCC uses informal and formal enforcement actions to address violations of laws, rules, regulations, and unsafe and unsound practices or conditions.

[24] Ratings may also be assigned as a result of targeted examinations and in some cases, periodic monitoring activities.

Informal Enforcement Actions

When a bank's overall condition is sound but it is necessary to obtain written commitments from its board of directors to ensure that identified problems and weaknesses will be corrected, OCC may use informal enforcement actions. Informal enforcement actions provide a bank with more explicit guidance and direction than a report of examination normally contains but are generally not legally binding.

Informal enforcement actions include commitment letters, memoranda of understanding, and 12 C.F.R. Part 30 safety and soundness plans. Commitment letters and memoranda of understanding contain specific bank commitments to take corrective actions in response to problems or concerns identified by OCC in its supervision of the bank. Part 30 informal enforcement actions require the bank to submit a compliance plan for OCC approval that outlines the steps the bank will take and timeframes to correct identified deficiencies. Failure to submit a timely, acceptable plan or failure to comply with a plan once it has been accepted is a basis for a public, enforceable order. Unlike formal enforcement actions, informal actions are not disclosed to the public.

Formal Enforcement Actions

Formal enforcement actions are authorized by statute, generally more severe, and disclosed to the public. Formal actions are also enforceable through the assessment of civil money penalties and, with the exception of formal agreements, through the federal court system. Formal enforcement actions available to OCC include consent orders, cease and desist orders, formal written agreements, and prompt corrective action directives.

OCC Enforcement Guidelines

OCC policy specifies that determining the appropriate enforcement action, whether informal or formal, depends on the following:

- the overall condition of the bank;

- the nature, extent, and severity of the bank's problems and weaknesses;

- the commitment and ability of bank management to correct the identified deficiencies; and

- the existence of previously identified but unaddressed problems or weaknesses.[25]

[25] OCC Policies and Procedures Manual 5310-3 (Rev.)

Adversely classified asset	An asset rated as substandard, doubtful, or loss. Substandard assets are inadequately protected by the current worth and paying capacity of the obligor or of the collateral pledged, if any. A doubtful asset has all the weaknesses of a substandard asset with the added characteristic that the weaknesses make collection or liquidation in full questionable and improbable. A loss asset is considered uncollectible and of such little value that continuation as a bankable asset is not warranted.
Allowance for loan and lease losses	An estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid.
Brokered deposit	Any deposit that is obtained, directly or indirectly, from a deposit broker. Under 12 U.S.C. 1831f and 12 C.F.R. 337.6, the use of brokered deposits is limited to well-capitalized insured depository institutions and, with a waiver from the Federal Deposit Insurance Corporation (FDIC), to adequately capitalized institutions. Undercapitalized institutions are not permitted to accept brokered deposits.
Call report	A quarterly report of income and financial condition that banks file with their regulatory agency. The contents of call reports include consolidated detailed financial information on assets, liabilities, capital, and loans to executive officers, as well as income, expenses, and changes in capital accounts.
CAMELS	An acronym for performance rating components for financial institutions: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Numerical values range from 1 to 5 with 1 being the best rating and 5 being the worst. The Office of the Comptroller of the Currency (OCC) uses the CAMELS rating system to evaluate a bank's overall condition and performance by assessing each

	of the six rating components and assigning numerical values. OCC then assigns each bank a composite rating based on its assessment of the overall condition and level of supervisory concern.
Capital Purchase Program	The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-342, 122 Stat. 3267, section 101(a) authorized Treasury to establish the Troubled Assets Relief Program to, among other things, purchase troubled assets from financial institutions. Under this authority, Treasury created a voluntary program--the Capital Purchase Program in which the United States government, through the Department of the Treasury, invests in preferred equity securities issued by qualified financial institutions.
Capital restoration plan	Under the prompt corrective action requirements of the Federal Deposit Insurance Act, a capital restoration plan is to be submitted to the appropriate federal banking agency by any undercapitalized insured depository institution. A capital restoration plan specifies the steps the insured depository institution is to take to become adequately capitalized, the levels of capital to be attained during each year in which the plan is in effect, how the institution is to comply with the restrictions or requirements then in effect, the types and levels of activities in which the institution is to engage, and any other information that the federal banking agency may require.
Collateralized mortgage obligation	A type of mortgage-backed security. The cash flows underlying collateralized mortgage obligations (CMO) are ordered into tranches by some characteristic (such as repayment time), with each tranche sold as a separate security. Typically, CMO tranches are paid sequentially from the most senior (super senior to senior) to the most subordinate (mezzanine, then equity). The more senior tranches generally have higher credit ratings i.e., AAA, AA, or A than the subordinated tranches.

Commercial real estate loans	Loans for real property where the primary or significant source of repayment is from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property. Commercial real estate loans include construction and real estate development, land development, and commercial properties such as office buildings and shopping centers.
Concentration risk	Risk in a loan portfolio that arises when a disproportionate number of an institution's loans are concentrated in one or a small number of financial sectors, geographical areas, or borrowers.
Full-scope examination	Examination activities performed during the supervisory cycle that (1) are sufficient in scope to assign or confirm a bank's CAMELS composite and component ratings; (2) satisfy core assessment requirements; (3) result in conclusions about a bank's risk profile; (4) include onsite supervisory activities; and (5) generally conclude with the issuance of a report of examination.
Loan participation	The sharing of a loan by a group of banks that join together to make a loan too large for any one of the banks to handle. Loan participation is a convenient way for smaller banks to book loans that would otherwise exceed their legal lending limits (see loan-to-value for limits).
Loan-to-value	A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral. In accordance with Interagency Guidelines for Real Estate Lending Policies, institutions' internal loan-to-value limits should not exceed the legal lending limit: (1) 65 percent for raw land; (2) 75 percent for land development; (3) 80 percent for commercial, multifamily, and other nonresidential loans; and (4) 85 percent for one-family to four-family residential loans The guidelines do not specify a limit for owner-

	occupied one-family to four-family properties and home equity loans. However, when the loan-to-value ratio on such a loan equals or exceeds 90 percent at the time of origination, the guidelines state that the bank should require mortgage insurance or readily marketable collateral.
Matter requiring attention	A bank practice noted during an OCC examination of a bank that deviates from sound governance, internal controls, and risk management principles. The matters, if not addressed, may adversely impact the bank's earnings, capital, risk profile, or reputation, or may result in substantive noncompliance with laws and regulations, internal policies or processes, OCC supervisory guidance, or conditions imposed in writing or other requests by a bank. Although matters requiring board attention are not formal enforcement actions, OCC requires that banks address them. A bank's failure to do so may result in a formal enforcement action.
Prompt corrective action	A framework of supervisory actions, set forth in 12 U.S.C. §1831o, for insured depository institutions that are not adequately capitalized. It was intended to ensure that action is taken when an institution becomes financially troubled in order to prevent a failure or minimize resulting losses. These actions become increasingly severe as a bank falls into lower capital categories. The capital categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The prompt corrective action minimum requirements are as follows:

Capital Category	Total Risk-Based		Tier 1/ Risk-Based		Tier 1/ Leverage
Well-capitalized[a]	10% or greater	and	6% or greater	and	5% or greater
Adequately capitalized	8% or greater	and	4% or greater	and	4% or greater (3% for 1-rated)
Undercapitalized	Less than 8%	or	Less than 4%	or	Less than 4% (except for 1-rated)
Significantly undercapitalized	Less than 6%	or	Less than 3%	or	Less than 3%
Critically undercapitalized	Has a ratio of tangible equity to total assets that is equal to or less than 2 percent. Tangible equity is defined in 12 C.F.R. § 565.2(f).				

[a] To be well-capitalized, a bank also cannot be subject to a higher capital requirement imposed by OCC.

Risk-based capital — The sum of Tier 1 plus Tier 2 capital.

Risk-weighted asset — An asset rated by risk to establish the minimum amount of capital that is required within institutions. To weight assets by risk, an institution must assess the risk associated with the loans in its portfolio; institutions whose portfolios hold more risk require more capital.

Structured investment securities — Products that are part of the securitization market. In an asset-backed security, the cash flows from the underlying assets (collateral) can be allocated to investors in different ways. Cash flows (payment streams) can be "passed-through" directly to the investors or carved up according to specific rules and investor demand, thereby creating "structured" investment securities. These various structures meet the needs of different investor types by allowing them to invest in a product that meets their risk appetite and collateral and earnings requirements. These securities include private label mortgage-backed securities, resecuritizations, and trust-preferred securities.

Targeted examination — A bank examination that does not fulfill all of the requirements of a statutory full-scope examination.

	Targeted examinations may focus on one particular product, function, or risk, or they may cover specialty areas.
Tier 1 capital	Common shareholder's equity (common stock, surplus, and retained earnings), noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.
Tier 2 capital	Subordinated debt, intermediate-term preferred stock, cumulative and long-term preferred stock, and a portion of a bank's allowance for loan and lease losses.
Tranches	Portions of a related group of securities that are offered simultaneously but that have different risks, rewards, or maturities. A typical CMO consists of tranches of underlying mortgages with different characteristics, such as repayment time. Tranches are categorized from senior to subordinate. Senior tranches generally have higher credit ratings than subordinated tranches.

The following chronology describes significant events in the history of Citizens National Bank (CNB), including examinations conducted and enforcement actions taken by the Office of the Comptroller of the Currency (OCC). For additional information on the results of examinations, including any significant safety and soundness matters requiring attention and recommended actions, see appendix 5.

1890	CNB is established as an Illinois state bank.
1939	CNB converts to a national bank charter.
4/27/2005	Citizens Central Bancorp's (CCB) board agrees to sell CNB to JGS Investment Group, of Oak Brook, Illinois.
7/22/2005	CCB's shareholders ratify the sale of CNB to JGS Investment Group.
10/27/2005	The Board of Governors of the Federal Reserve Board approves the application for the formation of CCB Acquisition Corporation, Oak Brook, Illinois, to wholly acquire CCB and, thus wholly acquire CNB. CCB's chief executive officer and chairman of the board begins to actively manage CNB.
11/3/2005	OCC begins a full-scope examination of CNB, with financial information as of September 30, 2005, resulting in CAMELS composite and component ratings of 1/111212.
1/31/2006	The acquisition of CNB is completed, and new boards for CCB and CNB are elected.
9/25/2006	OCC reviews the changes by CNB's new board and management made to its investment portfolio and balance sheet. OCC begins an interim review as of June 30, 2006, resulting in CAMELS composite and component ratings of 1/111212.
3/1/2007	CNB opens a loan production office in Oak Brook, Illinois.
5/21/2007	OCC begins a full-scope examination of CNB with financial information as of March 31, 2007, resulting in CAMELS composite and component ratings of 1/121212.

7/30/2007	CNB's June 30, 2007, call report, indicates that CNB's total risk-based capital ratio has caused the bank's capitalization category for prompt corrective action (PCA) purposes to drop from well-capitalized to adequately capitalized.
7/31/2007	CCB injects $1.75 million into CNB to make the bank well capitalized.
4Q 2007 and 1Q 2008	CNB purchases $66 million in private label collateralized mortgage obligations (CMOs).
4/07/2008	OCC conducts a review of CNB's commercial real estate (CRE) loan participations.
7/7/2008	OCC begins a targeted examination of CNB, which focuses on the bank's commercial real estate loan participations. The examination results in assignment of CAMELS composite and component ratings of 3/342232.
7/30/2008	CNB's PCA category declines from well-capitalized to adequately capitalized based on information in its June 30, 2008, call report.
8/5/2008	CCB injects $1 million into CNB.
8/28/2008	OCC's Peoria field office notifies CNB that it is adequately capitalized. The notice informs CNB that the adequately capitalized category prohibits CNB from accepting or renewing brokered deposits without a waiver from the Federal Deposit Insurance Corporation and restricts the effective yield that CNB can offer on deposits.
10/30/2008	CNB's PCA category declines to undercapitalized based on information in its September 30, 2008, call report.
11/3/2008	OCC begins a full-scope examination as of September 30, 2008, resulting in CAMELS composite and component ratings of 5/555533. OCC's Peoria field office notifies CNB that it is undercapitalized and requires CNB to submit a capital restoration plan (CRP) no later than December 15, 2008.

11/14/2008	CCB requests financial assistance from the Department of the Treasury pursuant to the Emergency Economic Stabilization Act of 2008. OCC is unable to recommend approval of CCB's request.
11/28/2008	OCC's Peoria field office transfers supervision of CNB to OCC's Special Supervision Division due to the bank's deteriorating financial condition.
12/15/2008	CNB submits a CRP.
1/26/2009	The director of the Special Supervision Division notifies CNB that its CRP is not acceptable and requests that CNB submit a revised plan by February 2, 2009.
1/30/2009	CNB's PCA category declines to significantly undercapitalized based on information in its December 31, 2008, call report.
2/5/2009	OCC informs CNB that the bank needs at least $27 million in new capital to address its risks and to restore it to the adequately capitalized category for PCA purposes. The director of the Special Supervision Division informs CNB's board that the bank is significantly undercapitalized for PCA purposes and again directs CNB to submit an acceptable CRP by March 2, 2009.
3/20/2009	The director of the Special Supervision Division issues a Notice of Intent to Issue a PCA Directive.
3/30/2009	CNB responds to OCC's notice and indicates that it did not submit another CRP because it had no prospects for obtaining the significant amount of capital that it needs.
4/16/2009	CNB's chief executive officer enters into two written agreements with the Federal Reserve Board, one on behalf of CCB and one on behalf of Strategic Capital Bancorp, the holding company of Strategic Capital Bank. Both written agreements restrict CCB and Strategic Capital Bancorp from declaring or paying dividends, receiving dividends from CNB and Strategic Capital Bank, respectively, incurring debt, and redeeming shares.

4/21/2009	CCB's independent public accounting firm notifies CCB that it is unable to complete the audit and form an opinion on the financial statements for CCB and CNB. The firm declines to issue a report and terminates its engagement with CCB.
4/22/2009	The director of Special Supervision Division issues a PCA Directive to CNB.
5/15/2009	To comply with the April 22, 2009, PCA Directive, CNB submits a CRP based on the one it submitted on December 15, 2008. The CRP provides for a capital infusion of $29 million from a potential sale of CNB and a reduction of assets and liabilities, including reducing deposits, Federal Reserve Board advances, private-label CMOs, municipal securities holdings, and loans.
5/20/2009	OCC notifies CNB that the revised CRP is not acceptable because although CNB identified potential investor groups, no purchaser had signed a binding agreement or filed any applications with the appropriate federal agencies. The CRP did not identify alternative sources of capital in the event that CNB was not sold.
5/22/2009	OCC closes CNB and appoints the Federal Deposit Insurance Corporation as receiver.

Date Started/ Type of exam	CAMELS ratings	Assets ($millions)	Significant safety and soundness matters requiring attention and recommendations cited in reports of examination.	Formal enforcement action
11/3/2005 **(Full-scope examination)**	1/111212	$230	**Matters requiring attention** • None identified. **Recommendations** • Improve and upgrade credit memos with respect to the hotel/motel loans. • Reevaluate the methodology used to determine the allowance for loan and lease losses (ALLL) balance with respect to the arbitrary weights given to pools of loans, including substandard and doubtful loans.	None
9/25/2006 **(Interim review)**	1/111212	$270	**Matters requiring attention** • None identified. **Recommendations** • None made.	None
5/21/2007 **(Full-scope examination)**	1/121212	$329	**Matters requiring attention** • Enhance the methodology and analysis in determining the adequacy of the ALLL as detailed in Office of the Comptroller of the Currency (OCC) Bulletin 2006-47. • Improve risk management practices commensurate with the level of risk posed by a portfolio with a significant concentration in commercial real estate lending as detailed in OCC Bulletin 2006-46. • Improve the structure of loan operations, enhance the quality and quantity of information in loan presentations, perform global cash flow analyses, increase the use of loan covenants, and improve the loan officer credit file memorandums. • Improve monitoring of loan participations purchased as detailed in OCC Banking Circular 181. • Improve investment loan credit monitoring and comply with 12 C.F.R. 1. Going forward, the purchase of all nonrated bonds should be preceded by a formal credit analysis. **Recommendations** • Implement a process by which model inputs are occasionally independently validated. A model validation process should be consistent with the expectations outlined in OCC Bulletin 2006-16, Risk Modeling and Validation. • Consider using a static balance sheet (i.e., no loan/deposit growth or runoff) in the base Bank Reporting Sciences model run to better capture current risk in the	None

Date Started/ Type of exam	CAMELS ratings	Assets ($millions)	Significant safety and soundness matters requiring attention and recommendations cited in reports of examination.	Formal enforcement action
			balance sheet. • Monitor pricing tendencies and runoff of nonmaturity deposits to better gauge rate sensitivity and to determine the accuracy of decay rates of nonmaturity deposits used within the model. • Amend the money market deposit account Trust Fund correlation from the 10 percent currently being used in the Bank Reporting Sciences model. That correlation is very low and probably does not truly represent the price sensitivity of that account. • Assign different deposit correlations to different tiers. High deposit tiers generally contain a higher degree of rate sensitivity, and that assertion is supported by the actual deposit account rate changes during the last 14 months. • Consider running alternative rate scenarios on occasion (ramping, yield curve steepening, flattening, inversion, etc.) to identify potential quantifications/vulnerabilities.	
7/7/2008 **(Targeted Examination)**	3/342232	$461	**Matters requiring attention** • Augment capital levels to achieve a well capitalized designation and provide sufficient Tier I capital commensurate with the bank's risk profile. • Reduce classified loan and investment levels. • Closely monitor heightened liquidity risks caused by capital designation, credit deterioration, and potential adverse public reaction. • Fully address credit, liquidity and ALLL issues highlighted as matters requiring attention in the May 2007 report of examination. **Recommendations** • Utilize an effective risk-rating system, including split ratings when appropriate. • Ensure that reappraisals or appraisal updates are obtained on all real estate-secured credits when significant market or project changes have occurred or when a material increase in credit risk has been identified. • Expand the use and enforcement of meaningful financial and nonfinancial loan covenants.	None

Date Started/ Type of exam	CAMELS rating	Assets (millions)	Significant safety and soundness matters requiring attention, corrective actions, recommendations, and other issues cited in reports of examination	Formal enforcement action
11/3/2008 **(Full-scope examination)**	5/555533	$452	**Matters requiring attention (directed at the board)** • Immediately infuse or seek at least an additional $27 million to support the bank's elevated risk profile and the bank. • Actively and effectively participate in board committee meetings and ensure that management operates within the parameters that have been established by the board's policies. • Establish concentration risk limits and risk management systems that enable the board to effectively identify, measure, and control this risk. **Recommendations** • None made.	PCA Directive 4/22/2009

Source: OCC reports of examination and call reports.

We have completed seven mandated material loss reviews of failed banks since November 2008. This appendix provides our recommendations to the Office of the Comptroller of the Currency (OCC) resulting from these reviews. With one exception as footnoted in this appendix, OCC management concurred with the recommendations and has taken or planned corrective actions that are responsive to the recommendations. In certain instances, the recommendations address matters that require ongoing OCC management and examiner attention.

Report Title	Recommendations to the Comptroller
Safety and Soundness: Material Loss Review of ANB Financial, National Association, OIG-09-013 (Nov. 25, 2008) OCC closed ANB Financial and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on May 9, 2008. At that time, FDIC estimated that ANB's failure would result in a loss to the Deposit Insurance Fund of $214 million.	Re-emphasize to examiners that examiners must closely investigate an institution's circumstances and alter its supervisory plan if certain conditions exist as specified in OCC's Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution. Re-emphasize to examiners that formal action is presumed warranted when certain circumstances specified in OCC's Enforcement Action Policy (PPM 5310-3) exist. Examiners should also be directed to document in the examination files the reasons for not taking formal enforcement action if those circumstances do exist. Reassess guidance and examination procedures in the Comptroller's Handbook related to bank use of wholesale funding with focus on heavy reliance on brokered deposits and other nonretail deposit funding sources for growth. Establish in policy a "lessons-learned" process to assess the causes of bank failures and the supervision exercised over the institution and to take appropriate action to address any significant weaknesses or concerns identified.
Safety and Soundness: Material Loss Review of First National Bank of Nevada and First Heritage Bank, National Association, OIG-09-033 (Feb. 27, 2009) OCC closed First National Bank of Nevada and First Heritage Bank and appointed FDIC as receiver on July 25, 2008. As of December 31, 2008, FDIC estimated that the banks' failures would result in losses to the Deposit Insurance Fund of $706 million for First National Bank of Nevada and $33 million for First Heritage Bank.	Re-emphasize to examiners the need to ensure that banks take swift corrective actions in response to examination findings. Re-emphasize to examiners OCC's policy on the preparation of supervision workpapers (i.e., workpapers are to be clear, concise, and readily understood by other examiners and reviewers).

Safety and Soundness: Material Loss Review of National Bank of Commerce, OIG-09-042 (Aug. 6, 2009) OCC closed National Bank of Commerce and appointed FDIC as receiver on January 16, 2009. As of June 30, 2009, FDIC estimated that the failure of National Bank of Commerce would result in a loss to the Deposit Insurance Fund of $92.5 million.	Conduct a review of investments by national banks for any potential high-risk concentrations and take appropriate supervisory action. Reassess examination guidance regarding investment securities, including government-sponsored enterprises securities.
Safety and Soundness: Material Loss Review of Ocala National Bank, OIG-09-043 (Aug. 26, 2009) OCC closed Ocala National Bank and appointed FDIC as receiver on January 30, 2009. As of August 7, 2009, FDIC estimated that the failure of Ocala National Bank would result in a loss to the Deposit Insurance Fund of $99.6 million.	Caution examiners and their supervisors that when a bank's condition has deteriorated, it is incumbent on examiners to properly support and document in examination workpapers the CAMELS component and composite ratings assigned, including those that may not have changed from prior examinations, as well as support a decision not to take an enforcement action. Remind examiners that it is prudent to expand examination procedures for troubled or high-risk banks to review the appropriateness of (a) dividends and (b) payments to related organizations, particularly when the dividends or payments may benefit bank management and board members. In this regard, OCC should reassess, and revise as appropriate, its examination guidance for when expanded reviews of dividends and related organizations should be performed.
Safety and Soundness: Material Loss Review of TeamBank, National Association, OIG-10-001 (Oct. 7, 2009) OCC closed TeamBank and appointed FDIC as receiver on March 20, 2009. As of September 18, 2009, FDIC estimated that TeamBank's failure would result in a loss to the Deposit Insurance Fund of $98.4 million.	Emphasize to examiners that matters requiring attention are to be issued in reports of examination in accordance with the criteria regarding deviations from sound management and noncompliance with laws and policies listed in the Comptroller's Handbook. Emphasize to examiners the need to (a) adequately assess the responsibilities of a controlling official (CEO/president, for example) managing the bank to ensure that the official's duties are commensurate with the risk profile and growth strategy of the institution;

	(b) review incentive compensation and bonus plans for executives and loan officers; and (c) ensure that banks conduct transactional and portfolio stress testing when appropriate.
Safety and Soundness: Material Loss Review of Omni, National Bank, OIG-10-017 (Dec. 9, 2009) OCC closed Omni, National Bank and appointed FDIC as receiver on March 27, 2009. As of October 31, 2009, FDIC estimated a loss to the Deposit Insurance Fund of $288.2 million.	Review OCC processes to ensure that more timely enforcement action is taken once the need for such action is identified.[26] Impress upon examiner staff the importance of completing all activities in annual supervisory cycles, including quarterly monitoring. In this regard, supervisors should ensure that quarterly monitoring activities are scheduled and carried out. Implement a policy for EIC rotation for midsize and community banks.
Safety and Soundness: Material Loss Review of Silverton Bank N. A., OIG-10-033 (Jan. 22, 2010) OCC closed Silverton Bank N.A. and appointed FDIC as receiver on May 1, 2009. As of October 31, 2009, FDIC estimated a loss to the Deposit Insurance Fund of $1.26 billion.	Ensure that after a charter conversion an EIC is promptly assigned and supervisory coverage of the institution is continuous, to include the timely initiation (within no more than 12 months of the full-scope examination by the prior regulator) of the first full-scope examination after conversion. Ensure that appropriate actions are taken to amend or reinforce OCC guidance in response to the lessons learned review of the Silverton failure. Ensure that banks seeking conversion to a national charter address all significant deficiencies identified by OCC or prior regulators before approval. Formalize the process for second level reviews of charter conversions.

[26] OCC did not agree with this recommendation. In its response to our report, OCC asserted that current policies are sufficient to ensure that timely enforcement action is taken. We accepted its position with respect to its current processes and consider the recommendation closed.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Michael J. Maloney, Director Fiscal Service Audits

From: John C. Dugan, Comptroller of the Currency /s/

Date: March 17, 2010

Subject: Response to Material Loss Review of Citizens National Bank

We have received and reviewed your draft report titled "Material Loss Review of Citizens National Bank." Your overall objectives were to determine the cause of the failure of Citizens National Bank (CNB); assess the OCC's supervision of the bank, including implementation of the Prompt Corrective Action (PCA) provisions of section 38(k); and make recommendations for preventing such a loss in the future.

You concluded that CNB failed because management pursued an aggressive growth strategy concentrated in high-risk private-label collateralized mortgage obligations (CMOs) and commercial real estate (CRE) loan participations, that were funded principally with brokered deposits. You also concluded that CNB experienced losses on subprime automobile loans and that CNB's board did not ensure that bank management identified, measured, monitored, and controlled the high risks associated with CNB's assets. Your report states that OCC could not have done anything significantly different to prevent CNB's failure and the material loss to the Deposit Insurance Fund. You concluded further that the OCC appropriately used its authority under PCA. We agree with these conclusions. The paragraphs below present our response to your specific recommendations.

Assess the Adequacy of OCC Bulletin 2009-15, Investment Securities

You recommended that due to the complexity of the risk-based capital treatment of structured investment securities the OCC should assess the adequacy of OCC Bulletin 2009-15, Investment Securities, after it has been in use for a reasonable time. We agree that it is important to have an ongoing process to assess the adequacy of our bank supervision policies. Our policy experts respond to questions from bankers and examiners regarding the application of policies such as Bulletin 2009-15 on an ongoing basis. This interaction enables them to recognize situations where clarifications or additional guidance are needed. In fact, the issuance of Bulletin 2009-15 was prompted by the questions examiners at CNB and other banks posed in the wake of unprecedented market events that were not clearly addressed by the existing policy guidance.

Work with Regulatory Partners to Determine Whether to Propose Appropriate Legislation and/or change Regulatory Guidance for Bank Investment Limits or Other Controls

The OCC works with other regulators to develop guidance on a variety of subjects where common issues or concerns exist. The Federal Financial Institutions Examination Council (FFIEC) and other interagency forums are evaluating a number of factors that contributed to the current problems in the banking industry and will consider what regulatory changes are needed. At this point, it is too early to say whether the final outcome of those deliberations will include changes in bank investment limits or risk management expectations, but I can assure you that we will continue to study the situation and interface with our regulatory partners when appropriate.

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

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Comptroller of the Currency
Senior Advisor—OIG/GAO Liaison

Office of Management and Budget

OIG Budget Examiner

Federal Deposit Insurance Corporation

Chairman
Inspector General

United States Senate

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

Chairman and Ranking Member
Committee on Finance

U.S. House of Representatives

Chairman and Ranking Member
Committee on Financial Services

U.S. Government Accountability Office

Acting Comptroller General of the United States