Audit Report

OIG-08-032

SAFETY AND SOUNDNESS: Material Loss Review of NetBank, FSB

April 23, 2008

Office of Inspector General

Department of the Treasury

Contents

Audit Report 1

Results in Brief 1

Background 5
NetBank History 5
Loans Sold with Recourse Provisions 9
Types of Examinations Conducted by OTS 10
Enforcement Actions Available to OTS 11
OTS Internal Assessments of the NetBank Failure 13

Results of Review 13

Causes of NetBank's Failure 13
Ineffective Business Strategies 14
Ineffective Internal Control Over Operations 17
High Operating Expenses and Losses 18
Lack of Consistent Core Earnings 19

OTS's Supervision of NetBank 19
Supervisory Weaknesses and Lessons Learned Noted by OTS Staff 20
Formal Enforcement Action Delayed After NetBank's Composite Rating Downgraded to 3 24
Internal Review Process Should Be Formalized in Policy 28

Recommendations 29

Appendices

Appendix 1: Objectives, Scope, and Methodology 32
Appendix 2: Chronology of Significant Events 34
Appendix 3: OTS NetBank Examinations and Enforcement Actions 42
Appendix 4: Management Comments 51
Appendix 5: Major Contributors to This Report 53
Appendix 6: Report Distribution 54

Abbreviations

ALLL	allowance for loan and lease losses
CEO	Chief Executive Officer
CMC	Commercial Money Center
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FNMA	Federal National Mortgage Association
FSB	Federal Savings Bank
G&A	general and administrative
IT	information technology
OIG	Department of the Treasury Office of Inspector General
OTS	Office of Thrift Supervision
PCA	Prompt Corrective Action
RBMG	Resource Bancshares Mortgage Group
ROE	report of examination

April 23, 2008

Mr. John M. Reich, Director
Office of Thrift Supervision

This report presents the results of our review of the failure of NetBank, FSB (NetBank), of Alpharetta, Georgia, and the Office of Thrift Supervision's (OTS)[1] supervision of the institution. Our review was mandated under section 38(k) of the Federal Deposit Insurance Act (FDIA), as amended. OTS closed NetBank and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on September 28, 2007. At that time, FDIC estimated that NetBank's failure would cost the Deposit Insurance Fund $108 million.

We conducted our fieldwork from October 2007 through March 2008 at OTS's headquarters in Washington, D.C.; and OTS's regional office in Atlanta, Georgia; FDIC's Division of Supervision and Consumer Protection in Atlanta, Georgia; and FDIC's Division of Resolutions and Receiverships in Dallas, Texas. We reviewed the supervisory files and interviewed key officials involved in the regulatory enforcement matters. Appendix 1 contains a more detailed description of our objectives, scope, and methodology.

Results in Brief

Causes of NetBank's Failure

Unfavorable economic conditions combined with ineffective business strategies and controls, high expenses (both marketing expenses and high cost of funds), and large losses related to a

[1] OTS is the primary federal regulator of federally chartered and state-chartered savings associations, their subsidiaries, and their registered savings and loan holding companies.

commercial lease portfolio and its mortgage banking operations were significant causes of NetBank's failure.

Beginning in 1997, NetBank's business strategy was to offer a broad range of banking and financial service products primarily through the Internet. To attract depositors, NetBank paid interest rates that were at the high end of the national averages and advertised heavily. At the same time, it embarked on an initial asset acquisition strategy where it purchased loans from other financial institutions. Included among its early acquisition of assets was a commercial lease portfolio from Commercial Money Center (CMC). While NetBank assumed that repayment of these leases were guaranteed, it later turned out that the leases were alleged to involve fraud and the insurance companies refused to honor the guarantees.

In 2001, NetBank shifted its strategy to focus on mortgage operations. In doing so, NetBank acquired Market Street Mortgage Corporation (Market Street), a retail residential mortgage origination company in June 2001. Then, in March 2002, NetBank acquired and merged with Resource Bancshares Mortgage Group (RBMG), a wholesale mortgage banking company. NetBank now relied almost exclusively on mortgage banking to generate earnings both through loan origination and the subsequent sale of those loans. It should also be noted that during this acquisition phase, NetBank never took advantage of economies of scale by consolidating common business functions.

While its mortgage banking operations did contribute substantially to NetBank's earnings, by mid 2005 these earnings began to contract. At the same time, the secondary mortgage market was experiencing a dramatic downturn. Rather than curtail its mortgage banking operations when faced with this deteriorating earnings scenario, NetBank instead attempted to increase loan production by lowering its underwriting and documentation standards. Not surprisingly, this led to poor loan quality. NetBank sold these loans on the secondary mortgage market with recourse provisions to investors. Recourse provisions outline the terms when the investor can request the thrift to buy back the loans. Ultimately, in 2006, NetBank had to make good on many of those provisions and repurchase $182 million in loans. Ultimately, when NetBank's mortgage operations became unprofitable, it did not have a profitable core business to fall back on.

OTS's Supervision of NetBank

OTS conducted timely and regular examinations of NetBank and provided oversight through its off-site monitoring. However, as discussed below, we noted that improvements are needed in the (1) use of internal OTS assessments, (2) timing of formal enforcement actions, and (3) OTS's internal reviews of thrift failures.

Around the time of the NetBank failure, OTS staff gathered information for OTS senior management on why NetBank failed and made a number of observations on the supervision exercised over the institution. Among the observations, regulators did not: focus sufficiently on the quality of sold loans being sold into the secondary market because the loans were not going into NetBank's portfolio, emphasize the need for NetBank to achieve consistently profitable core earnings separate from mortgage banking operations, require NetBank management to control expenses and control growth, and factor in the seriousness of the risks posed by the unexpected shutdown of NetBank's loan products flowing through the secondary market.

Other important lessons learned identified by OTS were the need to ensure: examiners are fully aware of the risks associated with mortgage banking operations, thrifts develop and follow viable business strategies, restrictions are imposed on thrifts when negative trends are present and thrift management has taken little or no action to address the situation, and examiners not view residential lending as a "low risk" concentration.

Based on our review of the examination records and reports and our interviews with OTS and FDIC staff, we affirm these observations and lessons learned in the internal assessment. OTS did not react in a timely and forceful manner to certain repeated indications of problems in NetBank operations. These indicators were NetBank's credit risk on loans sold with respect to repurchase exposure, NetBank's historically high general and administrative (G&A) expenses relative to its peers, its continually changing business plans, and significant variances in actual operating results compared to budget.

In an internal review of the NetBank failure, OTS staff indicated that the need for "trigger points" and contingency strategies to control mortgage operations had become apparent based on the contraction in the secondary market for nonconforming mortgage loans. Trigger points are conditions established by thrift management that, when reached, would require it to evaluate whether measures should be taken to address declining business lines. In this regard, we noted that the OTS Examination Handbook does not include procedures for reviewing trigger points or guidance for when OTS should require thrifts to use trigger points to address declining business lines.

We believe OTS should have used enforcement actions sooner to address these situations. While OTS eventually did take strong formal enforcement action in November 2006 through a supervisory agreement with NetBank, the conditions that collectively existed in March 2006, when OTS downgraded NetBank's composite rating from a 2 to a 3, suggests that a strong formal enforcement action should have been taken sooner.

In addition to the observations made and lessons learned made by OTS staff around the time of NetBank's failure, OTS issued a more extensive discussion of the failure in November 2007. While the *OTS Internal Bank Review* was suggestive that supervision of the institution should have focused more on certain high risk activities of NetBank, it did not include a specific assessment of OTS's supervision. The internal review also did not include any specific corrective actions OTS should take to address the areas of concern it identified. This was the first time OTS had undertaken such a review of a failed thrift. We believe that such reviews can produce useful information to improve OTS's supervisory process outside and in advance of material loss reviews by our office. Accordingly, we believe OTS should institutionalize the review process in policy.

Recommendations

We are recommending that OTS (1) ensure that the recommendations/lessons learned from internal assessments of the NetBank failure are implemented, (2) re-emphasize to examiners that for 3-rated thrifts, formal enforcement action is presumed warranted when certain circumstances are met and to document the reasons when formal enforcement action is not taken, and (3) establish in policy a process to assess the causes of thrift failures and the supervision exercised over the institution and to take appropriate action to address any significant supervisory weaknesses or concerns identified.

OTS Response and Office of Inspector General (OIG) Comments

OTS agreed with our overall review results and recommendations as noted in an April 21, 2008 written response to our draft report. For the full text of OTS's response to the draft report, see Appendix 4.

We believe OTS's planned actions are responsive to the intent of our recommendations.

Background

NetBank History

NetBank was established in 1988 as Allatoona Federal Savings Bank and renamed Premier Bank in 1995. NetBank Inc., the parent holding company for NetBank, was formed in 1996 and raised $38.4 million through an initial public offering of 3.5 million shares in 1997. NetBank Inc. used these proceeds to acquire Premier Bank and the Internet banking division of Carolina First Bank. The thrift was renamed Atlanta Internet Bank after the acquisition, Net.b@nk in 1998, and NetBank in 2000.

NetBank's business strategy beginning in 1997 was to operate as an Internet financial institution with no physical branch offices. The thrift's objective was to offer a broad range of banking and financial service products primarily through the Internet. Initially loans were not offered via the Internet, and the loans within the thrift's portfolio were purchased from other financial institutions.

NetBank Inc. was able to raise significant amounts of capital from investors. Including the initial stock offering, two additional stock offerings, and a subordinate debt issue, NetBank Inc. raised over $335 million, all within the first year of its initial offering. Most of these proceeds were infused into, or loaned to, NetBank.

NetBank relied on the Internet to attract depositors, which turned out to be a high-cost approach. Specifically, NetBank attracted internet depositors by offering high interest rates. This resulted in high cost of funds and high marketing expenses relative to its peers. To cover the high cost of deposits and to attempt to achieve profitability, NetBank used the capital funding provided by NetBank Inc. to rapidly grow interest-earning assets.

NetBank also had higher G&A expenses compared to its peer group as shown in table 1 below.

Table 1 – Comparison of NetBank G&A Expenses to Peer Group (as a percentage of Average Assets)

Year	NetBank	Peer Group
2007 (thru 6/3/2007)	12.7%	2.5%
2006	7.0%	2.3%
2005	5.4%	2.3%
2004	5.2%	3.0%
2003	5.8%	3.2%
2002	5.0%	2.9%

Source: OIG Analysis of Uniform Thrift Performance Reports.[2]

However, OTS management cautioned that the G&A ratios for the UTPR peer group are not directly comparable to NetBank due to its concentration in mortgage banking. According to OTS, the thrift institutions comprising the UTPR peer group are mainly portfolio lenders, the G&A expenses of which are attributable to on-balance sheet operations. The G&A expenses of institutions with large mortgage banking operations, such as NetBank, are largely determined by off-balance sheet activities, i.e. the production, sale

[2] The Uniform Thrift Performance Report (UTPR) provides measures of an individual thrift's performance as compared to its asset-size peer group performance.

and servicing of loans. Accordingly, mortgage banking operations typically record higher ratios of G&A expense to assets than portfolio lenders. Notwithstanding this, OTS also acknowledged that NetBank's G&A expenses were high throughout its life.

As noted above, NetBank's initial asset acquisition strategy relied on the purchase of loans from other financial institutions. As discussed in OTS's examination reports, an early concern with this strategy was NetBank's inadequate underwriting and monitoring of its purchased loan portfolio. This concern was substantiated with NetBank's purchase of the commercial lease portfolio from CMC. NetBank assumed repayment on these leases was guaranteed by insurance companies. The CMC leases were later alleged to involve fraud and led to legal costs for the thrift due to the insurance companies' refusal to honor their guarantees. NetBank incurred substantial losses associated with recording large loss provisions due to these assets being classified substandard. The pursuit of the CMC claims continues today.

NetBank changed strategy in 2001 by entering into mortgage banking. The thrift acquired Market Street Mortgage Corporation (Market Street), a retail residential mortgage origination company based in Florida, in June 2001. NetBank then acquired and merged with RBMG, a wholesale mortgage banking company located in South Carolina, in March 2002. Meritage Mortgage Corporation, which was acquired with RBMG, was initially held as a subsidiary of the holding company NetBank, Inc., but later moved under NetBank in 2004.

RBMG's mortgage banking activities dominated the operations of NetBank following the merger, and senior officials of RBMG replaced most of NetBank's existing management, including the Chief Executive Officer (CEO). The thrift's asset strategy changed to focusing on originating single-family mortgage loans for sale on the secondary market rather than accumulating long-term assets to be held in portfolio.

NetBank continued to add business lines in 2003 and 2004. The thrift acquired Financial Technologies Inc., a provider of ATM services for retail and nonbank businesses, in October 2003 and renamed it NetBank Payment Systems, Inc. In June 2004, NetBank acquired Beacon Credit Service, a provider of recreational vehicle, boat, and aircraft financing. This was part of NetBank's attempt to diversify its income sources, since all profits were coming from mortgage operations.

While the Market Street and RBMG acquisitions contributed to earnings, NetBank recorded a pre-tax loss of $19.1 million in 2002 due to a $20.1 million loss provision associated with the CMC leases. After recording a pre-tax $72.3 million net income in 2003, NetBank had a pre-tax net loss of $7.1 million in 2004 primarily due to additional loss provisions on the CMC leases. The thrift reported pre-tax net income of $6.2 million in 2005 despite the profitability of its subprime mortgage banking operations turning negative during the year even though loan production increased.

NetBank responded to declining gains on the sale of loans by attempting to maintain high loan volumes at the expense of the quality of loan originations. This resulted in an increase in repurchase requests from the buyers of the sold loans. The thrift repurchased $182 million of mortgage loans in 2006 and recorded related loss provisions totaling $78.1 million.

Beginning with the first quarter of 2006, NetBank began reporting increasing levels of quarterly losses. The thrift reported a pre-tax net loss of $203.6 million in 2006, with $80 million of that loss incurred in the fourth quarter. NetBank's other business lines were not sufficiently profitable to offset the mortgage banking losses and, in some cases, contributed to the reported loss. In October 2006, NetBank's chairman of the board/CEO resigned. NetBank paid him $2.9 million in severance pay. The former official was hired as a senior management official by another OTS-regulated thrift on or about August 2007.

In the latter half of 2006, NetBank management pursued several strategies to counter its losses, including selling several business lines and some loan portfolios and terminating the subprime mortgage banking operation. These strategies were not successful, as evidenced by the losses in 2006 which continued in 2007. An agreement to sell almost the entire thrift was entered into with EverBank Financial Corporation in May 2007. As NetBank sold off or exited business lines in preparation for the sale, its losses continued, totaling $120.2 million for the second quarter of 2007.

The sale to EverBank Financial Corporation was not consummated because NetBank did not have sufficient cash and saleable assets to close the transaction under the terms of the agreement. With no viable plan for the thrift to restore capital and achieve profitability, OTS exercised its authority to close the institution and appointed FDIC as receiver on September 28, 2007. The estimated loss to the Deposit Insurance Fund at the time of NetBank's closure totaled $108 million.

See Appendix 2 for a chronology of significant events regarding NetBank.

Loans Sold with Recourse Provisions

As part of NetBank's strategy, it sold loans that included recourse provisions to investors. Recourse provisions outline the terms when the investor can request the thrift to buy back the loans. An example is if the borrower defaults once within the first four payments, the thrift must buy back the loan. In addition to recording income at the time of the sale, the thrift will estimate the loss on buy backs. The estimate is based on the thrift's historical experiences. If it does not have a history, the thrift should analyze its peer historical losses and the recourse arrangements on the contracts. The estimate amount of loss is reported as a liability on the balance sheet.

Thrifts establish an allowance for loan and lease losses as a contra-asset account on the balance sheet for loans held for investment and held for sale[3]. In accordance with FIN 45,[4] a reserve is

[3] A valuation allowance is a contra account, established and maintained through charges against current earnings to absorb losses inherent in an institution's portfolio. Valuation allowances established to absorb unidentified losses inherent in an institution's overall loan and lease portfolio are referred to as the allowance for loan and lease losses (ALLL).

[4] Financial Accounting Standards Board (FASB) Interpretation No. 45 (FIN 45) is an interpretation of FASB Statements of Financial Accounting Standards (SFAS) 5 and 107. FIN 45 deals with Guarantor's accounting and disclosure requirements for guarantees, including indirect guarantees of indebtedness of others. SFAS 5 requires accrual by a charge to income and disclosure for an estimated loss from a loss contingency if certain conditions are met. SFAS 107 requires disclosure in the financial statements or in the accompanying notes of the fair value of financial instruments for which it is practicable to estimate.

established for loans sold with recourse which are considered off-balance sheet loans; and thus not reported as an asset on the balance sheet. FIN 45 states that savings associations should establish warranty reserves for loans sold that may be repurchased under the standard representations and warranties. The estimated amount of loss discussed above is recorded as a liability on the thrift's balance sheet and an expense on its income statement. Once a loan is repurchased, it is reported on the balance sheet as an asset and the reserves for these loans are transferred from the liability account to a repurchase reserve. The repurchase reserve is accounted for as a contra-asset account that reduces the book value of the repurchased loan portfolio.

Types of Examinations Conducted by OTS

OTS conducted various types of examinations of NetBank including comprehensive examinations, limited safety and soundness examinations, field visits, and information technology (IT) examinations. The comprehensive examination is a combined examination of the institution's safety and soundness and its compliance with applicable rules and regulations. Prior to July 2004, safety and soundness examinations and compliance examinations of NetBank were conducted separately. The safety and soundness portion of the examination included a review and evaluation of capital adequacy, asset quality, management effectiveness, earnings performance, liquidity and asset/liability management, and sensitivity to market risk. The compliance portion included an assessment of how well the institution manages compliance with consumer protection and public interest-related laws and regulations. The limited examination replaced the previously designated on-site and off-site supplemental examinations, field visit, and off-site monitoring. Prior to the implementation of the limited examination process, field visits were conducted to review specific areas of concern that OTS had about an institution. IT examinations included a review and evaluation of overall management of the information systems used by the thrift, as well as the effectiveness of the internal audit and security functions.

OTS, like other bank regulatory agencies, uses the Uniform Financial Institutions Rating System, commonly called the CAMELS ratings.[5] The CAMELS rating system provides a general framework for assimilating and evaluating all significant financial, operational, and compliance factors inherent in a bank. It enables the regulator to assign each banking organization individual CAMELS component ratings and an overall composite rating that indicates the institution's overall condition.

Enforcement Actions Available to OTS

As discussed above, OTS performs various examinations of thrifts resulting in the issuance of reports of examinations (ROE) identifying areas of concern. OTS uses informal and formal enforcement actions to address violations of laws and regulations and to address unsafe and unsound practices.

<u>Informal Enforcement Actions</u>

Common informal enforcement actions include (1) board of directors' resolutions[6] and (2) meetings with management and the board of directors. During meetings with management and the board of directors OTS may discuss findings and agree on corrective actions. Corrective actions are deficiencies and violations that are included in OTS's reports of examination and are communicated to the institution with the expectation that it will be corrected by the next examination. Corrective actions also include matters requiring board attention that are specific recommendations to correct major deficiencies and violations listed in the ROE. They require a formal response from the board of directors and are generally repeat corrective actions that have not been addressed by thrift management. Informal enforcement actions are not made public.

The effectiveness of the informal enforcement actions depends in part on the willingness and ability of the thrift to correct deficiencies that OTS notes. If the thrift violates or refuses to

[5] CAMELS is an acronym for the performance rating components: <u>C</u>apital adequacy, <u>A</u>sset quality, <u>M</u>anagement administration, <u>E</u>arnings, <u>L</u>iquidity, and <u>S</u>ensitivity to market risk. Numerical values range from 1 to 5, with 1 being the highest rating and 5 representing the worst rated banks.
[6] Board of directors' resolutions is a document designed to address one or more specific concerns identified by OTS and adopted by the thrift's board of directors.

comply, OTS cannot enforce compliance in federal court or assess civil money penalties for noncompliance.

Formal Enforcement Actions

If informal tools do not resolve noted problems, OTS may use formal enforcement tools, especially when there is a threat of harm to the institution, its depositors, or the public. A formal enforcement action is both written and enforceable under the FDIA.[7] OTS may assess civil monetary penalties against thrifts and individuals for noncompliance. OTS may also request a federal court to issue an injunction requiring the association to comply with an order. Unlike informal actions, formal enforcement actions are public. Common formal enforcement actions include supervisory agreements,[8] cease and desist orders, and civil money penalties.

OTS Enforcement Guidelines

Considerations for determining whether to use an informal supervisory response or take a formal enforcement action include:

- the extent of actual or potential damage, harm, or loss to the thrift because of the action or inaction;
- the likelihood that the conduct may occur again;
- the capability, cooperation, integrity, and commitment of the thrift's management, board of directors, and ownership to correct identified problems;
- the effect of the illegal, unsafe, or unsound conduct on other financial institutions, depositors, or the public;
- the examination rating of the thrift;

[7] 12 USC §1818(b) and §1831o.

[8] Supervisory agreements are formal written agreements entered into willingly by the thrift, and OTS uses them only with thrifts or their holding companies that are subject to OTS's continuing supervision and jurisdiction, not with individuals or other entities. OTS may use supervisory agreements to require thrifts or holding companies to cease any statutory or regulatory violation or unsafe or unsound practice.

- the presence of unique circumstances; and

- the supervisory goal OTS wants to achieve.

OTS Internal Assessments of the NetBank Failure

At the request of the OTS senior deputy director, OTS's Atlanta region provided an assessment of NetBank shortly before the institution was closed in September 2007. In working versions of that assessment, which was in the form of talking points and answers to specific questions by OTS senior management, OTS management identified a number of conditions at the thrift that led to its failure. OTS management also pointed out some areas where supervision could have been better. The assessment was done to prepare OTS senior management for questions on the failure once it was announced.

Following the failure of NetBank, OTS initiated an internal review to examine the causes of NetBank's failure and identify lessons learned for OTS staff. This was the first time OTS had undertaken an internal review following a thrift failure. A member of the OTS Examinations and Supervision Operations staff conducted the review. The staff member reviewed all relevant ROEs, examination workpapers from 2005 forward; OTS Regulatory Profiles, Quarterly Monitoring Reports, and Problem Bank Memoranda; Thrift Financial Reports; application documents; OTS memoranda and correspondence files; and Security and Exchange Commission filings. The *OTS Internal Bank Review* documents the history of NetBank, the causes of its failure, and lessons learned: it was completed on November 8, 2007.

Results of Review

Causes of NetBank's Failure

Unfavorable economic conditions, combined with ineffective business strategies and controls, high expenses, large losses, and the lack of consistent positive core earnings were the primary causes of NetBank's failure.

Ineffective Business Strategies

NetBank management did not address various critical challenges facing the institution. Its business plans continually evolved as a result of ever-changing business strategies and expansion into new lines of business. Significant variances between NetBank's actual results and its budgeted results occurred throughout its life. After entering into the mortgage business in 2001, management was also unable to successfully diversify its operations or respond to the deteriorating conditions in the mortgage banking industry on which it had overly relied.

Internet-Only Strategy

Beginning in 1997, NetBank utilized an Internet-only strategy. The bank's objective was to offer a broad range of banking and financial services products primarily through the Internet. Initially, NetBank did not offer loans via the Internet; instead, it purchased the loans in its portfolio from other financial institutions.

To attract depositors, NetBank offered high rates on deposits and incurred high marketing expenses. NetBank justified this strategy by claiming that operational costs were substantially lower because of the absence of actual "brick and mortar" branches. The Internet was a useful means of raising cash for NetBank, which obtained a large number of deposits because of the high interest rates offered. In addition, NetBank raised a large amount of capital through stock issuances in 1997 and 1999, during the Internet boom years. However, NetBank was unable to generate loans and other earning assets through the Internet and therefore purchased loans and leases and instituted fees to produce sufficient income to cover expenses. Throughout its existence, NetBank incurred high operating costs.

Mortgage Banking Strategy

NetBank changed strategy in 2001 by entering into mortgage banking. When it acquired Market Street in June 2001 and RBMG in early 2002, NetBank established a means, other than through purchases, to generate assets. As discussed above, Meritage Mortgage Corporation was acquired with RBMG.

Although NetBank's acquisition of RBMG was described as a merger, RBMG's mortgage banking activities dominated the operations of NetBank following the acquisition, and senior officials of RBMG replaced most of NetBank's existing management, including its CEO. NetBank's asset strategy changed from accumulating long-term assets to be held in portfolio to focusing on originating single-family mortgage loans for sale on the secondary market.

NetBank became heavily dependent on its mortgage banking operations, primarily through production and sale of loans. Its mortgage banking products included

- Alternative A loans that included features such as (a) no income verification, (b) no income/no asset/no employment verification, and (c) no ratio requirements;
- Federal National Mortgage Association (FNMA) Desktop Underwriter Expanded Approval loans that were designed to assist individuals with lower-quality credit;
- interest only loans, where the borrower initially repays only interest;
- FNMA community loans, designed to assist low-to-moderate-income borrowers, which offer high loan-to-value ratios, low down payment requirements, and flexibility with respect to the borrower's credit history;
- option Adjustable Rate Mortgage loans, which offer negative amortization and a repayment period of more than 30 years;
- construction loans granted to end-user owner-occupants; and
- prime mortgage loans offered to borrowers deemed to have good credit.

Table 2 details the contribution of NetBank's mortgage banking subsidiaries to its income:

Table 2: Net Income (Loss), 2002-2007 (in millions)

Year	Market Street	NetBank Funding (RBMG)[1]	Meritage[2]	NetBank mortgage operations income (loss)	Total NetBank income (loss)[4]
2002	$20.5	$8.7		$29.2	$(19.1)
2003	$29.7	$57.7		$87.5	$72.3
2004	$16.1	Unknown[5]	$15.0	Unknown[5]	$(7.1)
2005	$10.8	$(18.8)	$(10.8)	$(18.8)	$6.2
2006	$4.3	$(109.9)	$(80.4)	$(186.1)	$(203.6)
2007[3]	$(3.8)			$(3.8)	$(35.6)

[1] NetBank Funding (RBMG) was acquired in March 2002 and operated as a wholly-owned subsidiary of the thrift until October 2004, when it was merged into and operated as a division of the thrift. Net income for NetBank Funding (RBMG) in 2002 is for the 9 months ended December 31, 2002. NetBank Funding (RBMG) performed only servicing and hedging activities in 2007.

[2] Meritage was not part of thrift until 2004 and was closed in the 4th quarter of 2006.

[3] Thru March 31, 2007

[4] Net Income is before tax and extraordinary income.

[5] NetBank Funding (RBMG) had a net loss of $0.8 million for the 6 months ended June 30, 2004, Information for the second half of 2004 was not available.

The real estate mortgage market had grown due to demand for subprime loans,[9] demand for residential mortgage-backed securities issued by investment firms, and relatively low interest rates. After mid-2005, with rising interest rates and increased competition, the environment for mortgage banking began to deteriorate. NetBank, however, was not positioned to withstand the dramatic downturn in the mortgage banking and housing markets and was slow to react to the decline in the market.

Additional Business Lines

Since all its profits were coming from its mortgage operations, NetBank attempted to diversify its income sources by continuing to add business lines from 2003 through 2005. For example, NetBank acquired several ATM networks through NetBank Payment Systems, as well as other lending segments such as Beacon Credit Services (recreational vehicle, boat, and airplane lending) and NetBank Dealer Financial Services (automobile lending). These

[9] Subprime lending generally refers to extending credit to borrowers who exhibit significantly higher credit risk than prime borrowers.

efforts at diversification of income sources were unsuccessful because they were neither well-timed nor well-executed; they resulted in increasing NetBank's expenses and adding to its losses.

In the latter half of 2006, NetBank management pursued several strategies to counter the thrift's losses, including selling several business lines and some loan portfolios and terminating the subprime mortgage banking operation. These strategies were not successful, as evidenced by the losses in 2006. NetBank entered into an agreement to sell almost the entire thrift to EverBank Financial Corporation (EverBank) in May 2007. As NetBank sold off or exited business lines in preparation for the sale, its losses continued, totaling a reported $120.2 million for the second quarter of 2007.

The sale to EverBank was not consummated because NetBank did not have sufficient cash and saleable assets to close the transaction under the terms of the agreement. With no viable plan for the thrift to restore capital and achieve profitability, OTS exercised its authority to close the institution and appointed FDIC as receiver on September 28, 2007. NetBank's estimated losses at the time of closure totaled $108 million.

Ineffective Internal Controls Over Operations

Certain internal controls over NetBank's operations were ineffective. For example, rather than monitoring or instituting triggers to curtail its mortgage banking operations when economic conditions warranted such restrictions, NetBank's strategy continued to emphasize increased loan production, accomplished by lowering underwriting and documentation standards. Products such as "low-doc" and "no-doc" loans allowed borrowers to obtain loans without demonstrating their ability to repay the loan. In addition, underwriters reported to individuals who marketed and sold loans, and sales personnel pressured underwriters to approve loans.

Lowered underwriting standards led to poor loan quality, which led to loan repurchases, which led to large losses. In 2006, NetBank repurchased $182 million in loans that it had sold and ultimately booked $78 million dollars in loss provisions associated with the repurchases. The large losses resulting from loan repurchases significantly contributed to NetBank's failure.

High Operating Expenses and Losses

As previously discussed, NetBank's Internet deposit gathering strategy resulted in high marketing expenses. In addition, the high rates offered on deposits contributed to NetBank's high cost of funds, and its net interest margins were consistently below that of its peers. Further, NetBank never achieved economies of scale by consolidating business operations; staff were located in multiple locations and operated independently with little to no oversight. NetBank's attempts to diversify its operations increased its G&A expenses.

NetBank also incurred substantial losses on its CMC lease portfolio by relying too heavily on guarantees offered by sureties on the leases, rather than on its own due diligence to verify the quality of the leases. Between March 1999 and October 2000, NetBank purchased over $123 million worth of the lease pools from CMC based on financial guarantees made by various sureties. Beginning in December 2001, CMC failed to make its scheduled lease payments and declared bankruptcy in May 2002. Subsequently the sureties refused to make payments on their guarantees, and NetBank entered litigation to enforce collection from the sureties. According to the OTS 2002 and 2003 ROEs, the CMC leases were later alleged to involve fraud and led to legal costs for the thrift due to the insurance companies' refusal to honor their guarantees.

As of February 15, 2007, NetBank was owed $73.6 million in principal and $16.3 million in interest by the sureties. On August 21, 2007, NetBank entered into a settlement agreement providing for settlement of NetBank's pending claims against one of the sureties that insured the commercial leases that NetBank bought from CMC and the payment of $19.3 million to NetBank subject to court approval. As of the date of NetBank's dissolution—September 28, 2007, legal action to enforce collection and final resolution was ongoing.

Lack of Consistent Core Earnings

NetBank never established a consistent profitable core business, as shown in table below. NetBank offered relatively high interest rates on deposit accounts and covered these deposit costs by investing in a mix of loan portfolios with higher yields and credit risk. Rather than incurring loan origination costs, NetBank paid premiums to acquire loan portfolios necessary to achieve the asset mix it desired. The savings from not maintaining an in-house loan origination function did not prove adequate to compensate for the premiums paid for loans that the thrift purchased.

The net yield on the thrift's loan portfolios did not cover deposit costs and G&A expenses to the extent necessary to produce core earnings performance at the peer group median level. As a result, as discussed above, NetBank acquired Market Street and RBMG and became entirely dependent on mortgage operation income for profitability. The initial profitability of this segment masked underlying weaknesses, including unusually high operating expenses, ineffective controls of its various subsidiaries and insufficient core earnings.

Table 3: NetBank Core Earnings (in millions)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007 (thru 3/31
Core income/ (loss) after loss provisions	$2.0	$3.1	($3.4)	($3.4)	($44.4)	$68.8	($33.3)	($0.8)	($116.7)	($27.8)
Net income/(loss) (Pre-tax)	$2.0	$3.6	($2.9)	$9.9	($19.1)	$72.3	($7.1)	$6.2	($203.6)	($35.6)

Source: OIG analysis of OTS's ROEs for NetBank.

OTS's Supervision of NetBank

OTS conducted timely and regular examinations of NetBank and provided oversight through its off-site monitoring. Table 4 below summarizes the results of OTS's annual safety and soundness examinations and enforcement actions. Appendix 3 provides details of corrective actions, matters requiring board attention, and other examination findings.

Table 4 – Summary of OTS NetBank Examinations and Enforcement Actions

Date Started	Assets (in millions)	Examination Results: CAMELS Rating	Number of Corrective Actions	Number of Matters Requiring Board Attention	Formal Enforcement Actions
3/17/1998	$84	2/122212	7	-	None
5/24/1999	$511	2/122212	10	-	None
9/29/2000	$1,535	2/123222	15	-	None
1/2/2002	$2,867	2/222223	9	-	None
3/27/2003	$3,270	2/222222	9	-	None
7/30/2004	$4,849	2/222322	13	2	None
1/9/2006	$4,754	3/323332	28	6	None
11/2/2006	NA	4/423432 Off-site review	-	-	Supervisory agreement issued 11/6/2006
3/19/2007	$3,249	5/554555	6	5	None
8/3/2007	NA	PCA Notice[10]	-	-	Issued notice of undercapitalization[11]

Supervisory Weaknesses and Lessons Learned Noted by OTS Staff

Around the time of the NetBank failure, OTS staff gathered information on why NetBank failed so that OTS senior management would be prepared to answer questions about the failure once it was announced. In bullet points prepared for OTS senior management, the assessment noted the following:[12]

- regulators did not focus sufficiently on the quality of sold loans being sold into the secondary market because the loans were not going into the portfolio of the regulated thrift.

[10] Prompt Corrective Action (PCA) is a framework of supervisory actions, set forth in 12 USC §1831, for insured thrifts that are not adequately capitalized. It was intended to ensure that action is taken at the time an institution becomes financially troubled in order to prevent a failure or minimize resulting losses. These actions become increasingly severe as a thrift falls into lower capital categories. The capital categories are: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.

[11] NetBank maintained a well-capitalized categorization through the quarter ending March 31, 2007. During the next quarter, ending June 30, 2007, NetBank became undercapitalized. The PCA notice issued on August 3, 2007 required NetBank to file a capital restoration plan with OTS by September 13, 2007.

[12] The bullet points quoted below are from an internal OTS email dated September 25, 2007. The purpose of the email was to circulate a working draft of the talking points to OTS's Atlanta regional management and headquarters senior management. The final version of the bullet points focused on the causes of NetBank's failure, and did not include these points on OTS's supervision.

- exam reports did not emphasize the need for NetBank to achieve consistently profitable core earnings separate from mortgage banking operations.
- regulators should have required management to control expenses and control growth.
- regulators did not factor in the seriousness of the risks posed by the unexpected shutdown of non-agency products flowing through the secondary market.

The bullet points also included the following “lessons learned” from the failure:

- ensure examiners are fully aware of the risks associated with mortgage banking operations. Assess whether internal guidelines should be strengthened with an emphasis on internal controls to ensure the line of business is reviewed and assessed appropriately with immediate actions taken to remedy any concerns.
- renew emphasis on core earnings and ensure that concentrations in riskier mortgage channels are balanced with core delivery channels.
- ensure there is a viable business strategy that is followed. Any deviations need to be explored in depth to ensure they make sense for the institution. If changes continue, that is a reflection on management and should be addressed, as appropriate, through ratings and enforcement actions.
- impose or recommend restrictions when negative trends are present and management has taken little or no action to address the situation.
- educate examiners that residential lending can no longer be viewed as a “low risk” concentration. Depending on whether it is sold into the secondary market versus being held in portfolio, the types of delivery channels, volumes within these channels, the types of products being offered, the risks associated with them, and the underwriting standards.

Based on our review of the examination records and reports and our interviews with OTS and FDIC staff, we affirm the observations and lessons learned in the internal assessment. For example, we noted the following:

Quality of Sold Loans OTS did not sufficiently evaluate credit risk[13]. on loans NetBank sold with respect to repurchase exposure. In this regard, the OTS Examination Handbook does not include specific procedures for evaluating credit risk on sold loans.

As required by generally accepted accounting principles, NetBank established a reserve for sold loans for which investors could later demand that NetBank repurchase under the terms of the sale agreements (such as in the event of an early payment default). NetBank based the reserve on historical patterns of repurchase activities. However, the reserve proved to be inadequate because of the deteriorating quality of the loans NetBank was originating, particularly after NetBank reduced its underwriting standards following OTS's 2006 examination. In this regard, repurchases increased from $60 million in 2005 to $182 million in 2006. During its examinations, OTS examiners had tested the underlying assumptions and calculations supporting the reserve noting no exception. However, the examiners did not look at the credit quality of sold loans still in the hands of investors to assess the risk that they may have to be later repurchased by NetBank.

Control of Expenses NetBank had a history of high G&A expenses. OTS noted concerns about the level of G&A expenses in the 2000, 2002, 2003, and 2004 ROEs, but did not direct NetBank to take corrective action until the 2006 ROE. In this regard, the 2006 ROE directed NetBank management to improve its operating efficiency, including reducing expenses.

As it turned out, OTS overrelied on management's assurances and ability to address and control high G&A expenses. In an internal email, dated September 26, 2007, OTS's Atlanta regional deputy director states: (1) high G&A expenses and lack of efficiency in NetBank's operations were addressed repeatedly in examinations and in meetings with senior management; (2) NetBank's CEO presented a compelling case regarding efficiencies in their operations and steps they were taking to reduce expenses;

[13] Credit risk is the risk that borrowers will not repay their mortgages as agreed in the loan contract. While mortgage bankers typically do not hold mortgages for long periods after origination, they are still exposed to credit risk while they hold the loans for securitization or sale. Even after loans are sold, the mortgage banker is exposed to credit risk while standard representations and warranties are in effect. Loans in a mortgage banker's "held for sale" portfolios that are put back or become delinquent are considered "scratch and dent". Mortgage bankers generally have to sell such loans at a discount.

(3) NetBank management stated the losses in the mortgage operations were due to irrationally low pricing from undisciplined competition and cutting expenses would jeopardize loan quality and controls; and (4) NetBank's CEO had extensive experience in the market, was well informed regarding the details of all the thrift's operations and was able to provide them with information on steps they were taking to lower expenses. In actuality, the thrift did not control G&A expenses. We believe NetBank's history of high G&A expenses should have been addressed sooner than the 2006 ROE, and more forcefully.

<u>Viable Business Stategy</u> OTS noted but did not react to NetBank's continually changing business plans. As noted in the Background section of this report, NetBank began as an Internet-only thrift, then later expanded into retail, wholesale and subprime mortgage lending, insurance, ATMs, car loans, and recreational vehicle, boat, and aircraft financing. OTS did not indicate any concerns in its ROEs over the years about NetBank's continually changing business plans.

<u>Negative Trends</u> In the 1999, 2000, 2004, and 2005 ROEs, OTS reported that there were significant variances between NetBank's actual financial results and its budget. However, except for the 1999 ROE,[14] OTS did not direct NetBank to take any corrective actions related to these variances.

For example, in the 2004 ROE, OTS examiners reported that earnings were significantly lower than anticipated in the budget and that it was likely that total income for the year would lag budget projections by a substantial margin. For example, for the first two quarters of 2004, RBMG mortgage operations lost $584,000 compared to a budget of $7 million net income. OTS downgraded the earnings component of NetBank's CAMELS rating from a 2 to a 3 as a result of this deteriorating earnings trend as well as a large loss in the fourth quarter of 2004 related to CMC reserves. Despite the loss from RBMG operations and the downgrade to the earnings component, OTS did not prescribe any corrective actions in the ROE. In the 2005 ROE, examiners noted

[14] The 1999 ROE directed NetBank to modify its business plan to take into account that a June 1999 equity offering raised less capital than expected. While the ROE identified the actual capital amount raised, it did not identify the expected amount.

that Meritage mortgage operations lost $2.9 million compared to a budgeted net income of $9.6 million for the first 8 months of the year. Again, the ROE did not direct NetBank to take any corrective action to address the loss.

It should be noted that in the June 2006 ROE and the November 2006 supervisory agreement, OTS directed management to prepare variance reports that detail actual operating results versus projected results and include corrective actions for any material deviations. OTS also directed the board of directors to review the variance reports on a quarterly basis.

The *OTS Internal Bank Review* of the NetBank failure discussed that the need for "trigger points" and contingency strategies to control mortgage operations had become apparent based on the contraction in the secondary market for nonconforming mortgage loans. Trigger points are conditions established by thrift management that when reached would require it to evaluate whether measures should be taken to address at risk business lines. In this regard, we noted that the OTS Examination Handbook does not include specific procedures for reviewing trigger points or guidance for when OTS should require thrifts to use trigger points to address at risk business lines.

For example, as clearly demonstrated by the current subprime mortgage crisis, the mortgage market is cyclical. Without a contingency strategy involving trigger points, when the mortgage environment took a downturn, NetBank attempted to maintain their high level of loan production rather than reconsider whether the strategy was appropriate or that its mortgage operations should be scaled back. To accomplish this, NetBank weakened its underwriting standards, which led to increased loan repurchases and associated losses. Despite lowering the underwriting standards, NetBank's mortgage operations ultimately made fewer loans in 2006 than it did in 2005.

Formal Enforcement Action Delayed After NetBank's Composite Rating Downgraded to 3

On November 6, 2006, OTS entered into a supervisory agreement with NetBank's board of directors, the first time it took a formal enforcement action against the thrift. The enforcement action was taken shortly after OTS downgraded the thrift's composite rating to a 4 from a 3. We believe that formal enforcement action should have been taken sooner, if not at the time OTS downgraded the thrift's composite rating to 3 in March 2006, at least by the time it issued the 2006 ROE in June 2006.

According to section 370 of the OTS Examination Handbook, there is a *strong presumption* that thrifts with a composite rating of 4 or 5 warrant a formal action because they are more likely to fail. The Handbook also states that there is a *presumption* that a formal enforcement action is warranted for 3-rated thrifts under any of the following circumstances:

- Management is weak.
- There is uncertainty as to whether management and the board have the ability or willingness to take appropriate corrective measures.
- Conditions are rapidly deteriorating.
- The thrift has a rating of 3 for two consecutive examinations after entering into an informal enforcement action, unless the thrift complies with the informal enforcement action and no new grounds exist for taking a formal action.

We believe 2 of the 4 circumstances mentioned above were met at the time OTS completed the 2006 examination in May 2006. OTS noted in the 2006 ROE management's reluctance to shrink asset size or scale back operations and that plans to deal with deteriorating capital and earnings had not progressed. Additionally, conditions were rapidly deteriorating. For example, NetBank lost $8.9 million and $29.8 million in the first and second quarters, respectively, of 2006; NetBank's repurchases of sold loans were increasing; and NetBank had to obtain a capital infusion from NetBank Inc. to maintain its well-capitalized categorization.

OTS first noted deterioration in NetBank's financial condition in 2004. Based on its 2004 examination, OTS downgraded the earnings component of NetBank's CAMELS rating from a 2 to a 3. In October 2005, based on trends identified in the 2004 ROE, OTS conducted a field visit to assess NetBank's mortgage banking operations. OTS examiners found that NetBank was experiencing shrinking margins and an increase in the frequency and severity of losses resulting from mortgage loan repurchases. OTS was concerned about these losses—specifically with the recourse issues and the impact on capital. The ROE noted that the examiners discussed their concerns about capital and earnings with NetBank management before the end of the field visit. NetBank management indicated to the examiners that the thrift recognized OTS's concerns and was working on a defined strategy and plan to improve earnings and capital.

From January 9, 2006 to May 19, 2006, OTS conducted a comprehensive examination of NetBank. On March 29, 2006, during the examination, OTS notified NetBank that its composite CAMELS rating was downgraded from a 2 to a 3, along with downgrades to the capital, management, and liquidity component ratings. OTS's Atlanta regional management informed us that the rating change was made to assure that accurate and updated information on the bank's risk profile was available prior to the FDIC's quarterly assessment of risk.

As previously noted, the 2006 ROE was issued on June 16, 2006. The 2006 ROE reported, among many other things (1) a lack of management responsiveness to deterioration in profitability and capital levels, (2) material weaknesses in NetBank's planning and budgeting process as significant variances continued to be noted between budget and actual performance, and (3) a lack of progress in developing a plan to improve earnings and capital. The ROE also reported that NetBank had to get a capital infusion, via debt forgiveness, from NetBank Inc. to remain in the well-capitalized category of the PCA framework established by Congress. As discussed above, NetBank lost $8.9 million and $29.8 million in the first and second quarters, respectively, of fiscal year 2006.

NetBank responded to the examination report on August 21, 2006. OTS's Atlanta Region Supervisory Action Committee[15] met and approved the initiation of the supervisory agreement on September 25, 2006. Based on continued deterioration in capital

[15] Committee includes senior management officials of the OTS Atlanta region who determine if and when formal enforcement action will be taken. OTS order 96-72 delegated the authority to execute supervisory agreements to the regional directors. We were informed that each OTS region has a supervisory action committee.

and earnings levels, OTS issued the supervisory agreement to NetBank's board of directors on November 2, 2006, along with a notice to downgrade the thrift to a 4.

OTS management stated that the supervisory agreement was not issued earlier because: (1) OTS wanted to take into consideration what was occurring at the thrift subsequent to the period covered by the 2006 examination; (2) NetBank management had already started taking preliminary actions such as beginning the process to sell Meritage; and (3) NetBank management did not appear to be conducting unsafe and unsound business activities. OTS also gave consideration to the fact that attempts were being made to sell the institution to EverBank. In this regard, OTS was informed of the possible sale on May 3, 2006. On August 4, 2006, however, the NetBank board of directors rejected EverBank's offer.

While these factors may have been appropriate to consider; we believe these factors should not have delayed OTS's issuance of the supervisory agreement. We recognize that it is somewhat speculative to conclude that earlier and more forceful enforcement action would have prevented NetBank's failure or lessened losses to the deposit insurance fund. Nevertheless, based on the conditions existing when OTS downgraded NetBank to a 3, the increasingly deteriorating conditions noted beginning with the 2004 ROE, and the guidance in OTS Examination Handbook, these factors warranted OTS taking formal enforcement action sooner. If OTS had issued formal enforcement action earlier, NetBank might have acted more quickly or differently to address its problems.

It should be noted that on August 3, 2007, OTS issued to NetBank a PCA notice that it had determined that NetBank was undercapitalized. At that time, NetBank had not filed its June 30, 2007, Thrift Financial Report which was due July 30, 2007. NetBank was required by the notice to provide OTS a capital restoration plan by September 13, 2007. On August 10, 2007, NetBank filed its June 30, 2007, Thrift Financial Report and reported it was significantly undercapitalized. NetBank provided a capital restoration plan to OTS by letter dated September 13, 2007.[16] However, OTS was already moving to close the institution by this due date.

Internal Review Process Should Be Formalized in Policy

As mentioned above, just prior to NetBank's failure, OTS staff assessed the causes of the failure to provide senior management with information in the form of talking points to answer questions that might be asked once the closing of NetBank was announced. In working drafts of the talking points, OTS staff identified lessons learned with respect to OTS's supervision of the institution. In response to our inquiries of what action OTS had taken to address the lessons learned, we were told that no specific actions had been initiated.

The *OTS Internal Bank Review* prepared after the thrift failed similarly identified a number of lessons from the NetBank failure:

- NetBank's history underscores the long held belief of OTS that monitoring of business plan execution is critical to the supervisory process.
- Modifying or adjusting the business plan on a continual basis is an indicator of concern regarding financial strategy and soundness.
- Corrective actions to address concentration risks or weak performance are necessary when negative trends are present and management has not taken effective action.
- Internal controls systems must be strong, commensurate with the risk and volume of activity, and enforced by the institution.
- Examiners and the industry need additional training and guidance pertaining to the potential risks in certain types of residential loan portfolios and mortgage banking operations.
- Through staff conferences, team meetings, and/or internal guidance, OTS should clearly communicate the lessons learned from this failure.
- The business plans that NetBank provided to OTS as part of the processing of applications, or through the examination function, did not contain established conditions (or trigger points) when management would be required to evaluate whether mortgage

[16] The capital restoration plan stated that NetBank intended to settle with an insurer of the CMC leases and make every effort to consummate the sale to EverBank.

> production should be scaled back or curtailed. With the recent contraction that has occurred in the secondary market for nonconforming mortgage loans, the need for such trigger points and contingency strategies has become more apparent.

While the *OTS Internal Bank Review* was suggestive that supervision of the institution should have focused more on certain high risk activities of NetBank, it did not include a specific assessment of OTS's supervision. It also did not include any specific corrective actions OTS should take to address the areas of concern it identified.

The *OTS Internal Bank Review* of NetBank was the first time OTS had undertaken such a review of a failed thrift. OTS did not have any specific policies and procedures in place for conducting the review. We were told that the review was modeled after a prior OIG material loss review of the OTS-regulated Superior Bank failure.[17]

We believe that conducting an internal review is an appropriate step to be taken when a financial institution fails. Such reviews can produce useful information to improve OTS's supervisory process outside and in advance of material loss reviews by our office. The performance of internal reviews represents an important internal control, defined in the Government Accountability Office's *Standards for Internal Control in the Federal Government* as the plans, methods, and procedures used to meet missions, goals, and objectives.[18]

Recommendations

We recommend that the Director of OTS do the following:

1. Ensure that the recommendations/lessons learned from OTS's internal assessments of the NetBank failure, as described on pages 21 and 28 of this report, are implemented.

[17] OIG-02-040, *Material Loss Review of Superior Bank FSB* issued Feb. 6, 2002.

[18] GAO/AIMD-00-21.3.1 (November 1999).

Management Response

OTS agreed with the recommendation and plans on implementing responsive actions to the recommendations/lessons learned from its internal assessments of the NetBank failure by June 30, 2008.

2. Re-emphasize to examiners that for 3-rated thrifts, formal enforcement action is presumed warranted when certain circumstances identified in OTS Examination Handbook are met. Examiners should also be directed to document in the examination files the reason for not taking formal enforcement action in those circumstances.

   Management Response

   OTS agreed with the recommendation and will issue an internal staff bulletin in May 2008 re-emphasizing the current enforcement action guidance in the OTS Examination Handbook for 3-rated institutions and the importance of documenting the reasons when a formal enforcement action is not pursued for a 3-rated institution.

3. Establish in policy a process to assess the causes of thrift failures and the supervision exercised over the institution and to take appropriate action to address any significant supervisory weaknesses or concerns identified.

   Management Response

   OTS agreed with the recommendation and has begun drafting an OTS policy that will require completion of a formal assessment for any future thrift failures. This new policy will be in place by May 31, 2008.

We believe OTS's planned actions are responsive to the intent of our recommendations.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-5776 or Jeff Dye, Audit Manager, at (202) 927-0384. Major contributors to this report are listed in appendix 5.

/s/
Susan L. Barron
Audit Director

We conducted this material loss review of NetBank in response to our mandate under section 38(k) of the Federal Deposit Insurance Act, as amended.[19] 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, 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.

We initiated a material loss review of NetBank based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of September 28, 2007, FDIC's Deposit Insurance Fund had recorded an estimated loss of $108 million.

To accomplish our review, we conducted fieldwork at the Office of Thrift Supervision 's (OTS) headquarters in Washington, D.C., and its regional office in Atlanta, Georgia. We also met with officials of FDIC's Division of Supervision and Consumer Protection in Atlanta, Georgia, and FDIC's Division of Resolutions and Receiverships in Dallas, Texas.

To assess the adequacy of OTS's supervision of NetBank, we performed interviews and reviews to determine (1) when OTS first identified NetBank's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OTS took to get the bank to correct the problems. We also performed interviews and reviews to determine whether OTS (1) might have discovered problems earlier, (2) identified and reported all the problems, and (3) issued comprehensive, timely, and effective

[19] 12 U.S.C. §1831o(k).

enforcement actions that dealt with any unsafe or unsound activities. Specifically, we:

- Reviewed OTS supervisory files and records for NetBank from 1997 through 2007. 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 OTS used to assess the thrift's condition, and the regulatory action used by OTS to compel thrift management to address deficient conditons. 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.

- Interviewed and discussed various aspects of the supervision of NetBank with OTS officials, examiners, an attorney, and an accountant to obtain their perspective on the thrift's condition and the scope of the examinations. We also interviewed FDIC officials who were responsible for monitoring NetBank for federal deposit insurance purposes.

- Interviewed FDIC Division of Receivership and Resolution personnel who were involved in the receivership process, which was conducted before and after NetBank's closure and appointment of receiver.

- Assessed OTS actions based on its internal guidance and legislative guidance provided by Federal Deposit Insurance Corporation Improvement Act, 12 U.S.C. 1820 (d).

Our review covered the period from 1997 until NetBank's failure on September 28, 2007. We conducted our fieldwork from October 2007 through March 2008. We conducted our review in accordance with generally accepted government auditing standards.

The following chronology describes significant events in NetBank's history, including examinations conducted and enforcement actions taken by the Office of Thrift Supervision (OTS).

3/21/1988	Institution is established under original name, Allatoona Federal Savings Bank (FSB).
4/28/1995	Allatoona FSB changes its name to Premier Bank FSB.
2/20/1996	NetBank Inc. is incorporated as a Georgia corporation.
7/28/1997	NetBank Inc. goes on sale to the public with an initial public offering of 3.5 million shares at $12 per share, which provided $38.4 million in proceeds. NetBank Inc. used a portion of the proceeds to buy Premier Bank and became its holding company.
8/1/1997	Premier Bank FSB changes its name to Atlanta Internet Bank and moves its headquarters from Acworth, GA, to Columbia, SC.
12/31/1997	Atlanta Internet Bank headquarters is moved from Columbia, SC, to Atlanta, GA.
2/20/1998	Atlanta Internet Bank headquarters is moved from Atlanta, GA, to Alpharetta, GA.
3/17/1998	OTS begins a safety and soundness exam. The exam was completed on 4/23/1998 and resulted in composite and CAMELS ratings of 2/122212.
9/8/1998	OTS conducts a field visit to Atlanta Internet Bank to follow up on the 3/17/1998 safety and soundness exam.
9/15/1998	Atlanta Internet Bank changes its name to Net.b@nk.
5/24/99	OTS begins a safety and soundness exam. The exam was completed on 8/6/1999 and resulted in composite and CAMELS ratings of 2/122212.
5/15/2000	Net.b@nk changes its name to NetBank.
9/29/2000	OTS begins a safety and soundness exam. The exam was completed on 12/6/2000 and resulted in composite and CAMELS ratings of 2/123222.

12/11/2000 OTS begins a field visit Commercial Money Center Inc. to address concerns regarding NetBank's purchase of commercial lease loans from CMC.

4/16/2001 NetBank enters into an agreement with Market Street Mortgage Corporation (Market Street), a subsidiary of Republic Bank, providing for the sale of Market Street to NetBank. Market Street was based in Clearwater, FL.

5/14/2001 OTS conducts a field visit of NetBank to review management's progress in addressing the required corrective actions from the 9/29/2000 examination. OTS issues a limited safety and soundness report on 5/17/2001.

7/13/2001 NetBank completes the acquisition of Market Street. The consideration paid at closing consisted of approximately 1.7 million shares of NetBank common stock and $4.0 million.

11/18/2001 NetBank and its subsidiary Palmetto Acquisition Corporation enter into an agreement with Resource Bancshares Mortgage Group (RBMG) providing for NetBank's acquisition of RBMG pursuant to the merger of Palmetto with and into RBMG, with RBMG surviving the merger. Immediately following the merger, the chief executive officer (CEO) of RBMG, becomes NetBank's CEO.

1/2/2002 OTS begins a safety and soundness exam. The exam was completed on 3/1/2002 and resulted in composite and CAMELS ratings of 2/222223.

2/11/2002 OTS begins an eligibility examination of RBMG.

2/28/2002 NetBank Inc. notifies Deloitte and Touche that in order to separate its internal and external audit functions, the company would change its external auditor to Ernst and Young (E&Y).

3/31/2002 NetBank completes the acquisition of RBMG, which began on 11/18/2001.

3/27/2003 OTS performs a safety and soundness exam. The exam was completed on 6/16/2003 and resulted in composite and CAMELS ratings of 2/222222.

10/6/2003 NetBank enters into an agreement to buy Financial Technologies Inc., a provider of ATM services.

6/10/2004 NetBank acquires the principal operating assets of Beacon Credit Service LLC, a privately held provider of recreational vehicle, boat, and aircraft financing. The purchase price was approximately $7.1 million.

6/15/2004 OTS approves NetBank's application to establish Meritage Mortgage Corporation (Meritage) as an operating subsidiary. Meritage, which originates nonconforming, mostly subprime first and second mortgage loans, becomes a subsidiary of NetBank.

7/30/2004 OTS performs a comprehensive exam. The exam was completed on 12/30/2004 and resulted in composite and CAMELS ratings of 2/222322.

12/31/2004 OTS designates NetBank as a qualified thrift lender. The designation allows the thrift to receive special benefits such as access to the Federal Home Loan Bank financing.

6/1/2005 Market Street enters into an asset purchase agreement with Major Mortgage (Major). Market Street was to acquire the assets of 27 of Major's residential mortgage loan production offices located in eight western states.

10/11/2005 OTS conducts a field visit of NetBank to assess its mortgage banking operation. OTS's report of examination (ROE) for the field visit states that NetBank's operating results had declined due to increased competitive pressure within the mortgage industry. The ROE also notes ongoing concern about NetBank's shrinking capital ratios.

11/9/2005 NetBank delays reporting third-quarter financial results due to an internal review of $13 million in conforming mortgage loans the company originated and sold to investors. Management was concerned of possible irregularities with the loans stemming from the appraisal and underwriting process. NetBank filed its 10Q[20] on November 14, 2005 after recording a provision of $3.5 million for these loans.

[20] The Form 10-Q is a quarterly report required by the Security and Exchange Commission (SEC) that includes unaudited financial statements and provides a view of the company's financial position during the year. The report must be filed for each of the first three fiscal quarters of the company's fiscal year.

1/9/2006	OTS begins a comprehensive exam. The exam was completed on 5/19/2006 and resulted in composite and CAMELS ratings of 3/323332. The report identified deficiencies in key operational areas, including insufficient and deteriorating capital and earnings levels.
3/29/2006	OTS downgrades NetBank's overall CAMELS rating from 2 to 3.
5/3/2006	NetBank informs OTS of a possible sale to EverBank.
6/16/2006	OTS's ROE for the 1/19/2006 exam is transmitted to NetBank. OTS requests that the thrift responds within 60 days.
8/4/2006	OTS regional director meets with NetBank senior management and is informed that the board of directors has rejected an offer from EverBank to purchase the thrift at book value.
8/21/2006	NetBank submits its response to the examination report.
9/25/2006	OTS's Atlanta region supervisory action committee meets and approves initiation of a supervisory agreement.
10/2/2006	NetBank's chairman of the board/CEO resigns. NetBank pays him $2.9 million severance.
10/10/2006	NetBank reported two events regarding its annual audit in an 8-K[21] filing with the SEC. As the first event, NetBank reported that E&Y resigned as its auditor. As the second event, NetBank reported that E&Y's 2004 Report on Internal Control Over Financial Reporting stated that NetBank's internal control over financial reporting was not effective because of a material weakness disclosed in those reports. The material weakness related to estimation of the change in fair value of mortgage loan funding commitments. NetBank addressed the weakness and E&Y agreed that the weakness was corrected.

[21] Public companies must report material corporate events on a more current basis. Form 8-K is the "current report" companies must file with the SEC to announce major events that shareholders should know about.

10/13/2006 NetBank sells most of its mortgage servicing rights associated with conventional, agency-eligible (i.e. Fannie Mae and Freddie Mac) loans. The unpaid principal balance of these loans totaled approximately $8.5 billion. The rights were sold in two separate transactions; the first involving the servicing rights for Fannie Mae and Freddie Mac loans with an unpaid principal balance of approximately $8.2 billion and the second transaction to sell a pool of Ginnie Mae rights with an unpaid principal balance of approximately $230 million.

11/2/2006 OTS meets with NetBank's board of directors and presents the supervisory agreement. OTS also delivers a notice that it has downgraded NetBank's CAMELS rating to a composite 4 from a 3 and designated the thrift as troubled. The downgrade was based on the deterioration in NetBank's capital and earnings, which was determined through off-site monitoring of NetBank's financial results performed after the conclusion of the 1/9/2006 comprehensive exam.

11/3/2006 NetBank's 8-K filing with the SEC reports the following events. NetBank commits to exit the company's nonconforming residential mortgage operation, resulting in Meritage entering into a personnel placement agreement with Lime Financial Services. All remaining operations of Meritage were shut down during the fourth quarter. NetBank also sells its recreational vehicle, boat, and aircraft financing operations.

11/6/2006 Supervisory agreement takes effect.

1/3/2007 OTS conducts a field visit at NetBank, with Federal Deposit Insurance Corporation (FDIC) examiners participating.

2/1/2007 The OTS regional director meets with NetBank's senior management. Senior management informs OTS that NetBank's subprime mortgage and auto lending operations are shut down. Senior management also informs OTS that sales of other smaller operations are pending. In light of unanticipated losses that threaten the thrift's capital compliance, the OTS regional director requests consideration of immediate sale of the thrift.[22]

2/13/2007 NetBank hires Porter Keadle Moore LLP as its new independent auditor following the resignation of its previous auditor, E&Y, in November 2006.

[22] Source is an internal OTS email dated September 26, 2007. Email documents OTS Atlanta region senior management's answers to questions from OTS senior deputy director.

3/19/2007	OTS begins a safety and soundness exam with FDIC examiners participating, including one from the FDIC Division of Resolutions and Receiverships. The exam was completed on 7/19/2007 and resulted in composite and CAMELS ratings of 5/554555.
4/2007	NetBank starts a shutdown of its wholesale mortgage banking division, NetBank Funding.
5/1/2007	NetBank's ATM and merchant-servicing operation, NetBank Payment Systems Inc., is sold to PAI ATM Services LLC, a subsidiary of Payment Alliance International Inc.
5/15/2007	NetBank Inc. receives a warning from National Association of Securities Dealers Automated Quotation (NASDAQ) as a result of filing its most recent quarterly report late.
5/18/2007	NetBank enters into a purchase agreement with EverBank. NetBank anticipated that the transaction would result in a loss of $60 - $70 million at close.
6/5/2007	OTS Atlanta regional director issues an informal enforcement action directing NetBank Inc. to divest NetBank as soon as possible.
6/15/2007	NetBank enters into a purchase agreement with EverBank. NetBank agrees to sell its remaining mortgage servicing rights to EverBank for approximately $27.2 million. NetBank had previously entered into a purchase agreement with EverBank dated 5/18/2007 transferring certain other assets and liabilities.
6/21/2007	NetBank files a Current Report on Form 8-K regarding its plan to shut down its mortgage servicing operations.
6/29/2007	The OTS regional director advises the FDIC regional director that in light of uncertainty regarding NetBank's ability to consummate the EverBank agreement, OTS does not object to the FDIC Division of Resolutions and Receiverships increasing its on-site presence at the thrift.
6/30/2007	NetBank's Thrift Financial Report for the quarter ending 6/30/2007 shows capital ratios that put NetBank's capital in the PCA undercapitalized category.

7/1/2007 EverBank takes over NetBank's $3.2 billion mortgage servicing portfolio.

7/3/2007 NetBank receives a deficiency notice from NASDAQ because its stock failed to close above the minimum price of $1 per share for the last 30 consecutive business days.

7/6/2007 OTS downgrades NetBank's composite CAMELS rating from 4 to 5 based on the safety and soundness exam started on 3/19/2007.

7/7/2007 An FDIC liquidation team begins an on-site review of NetBank.

7/19/2007 Porter, Keadle ,and Moore, LLP completes the audit of the holding company complex for the fiscal year ended December 31, 2006, but has not filed the 10K[23] as of July 19, 2007.

8/2/2007 NetBank receives notice of delisting from NASDAQ.

8/3/2007 NetBank receives notice from OTS that it is undercapitalized and is required to file a capital restoration plan with OTS by 9/13/2007.

8/7/2007 Trading of NetBank common stock is suspended.

8/16/2007 Two members of the NetBank Inc. board of directors resign.

8/21/2007 NetBank enters into a settlement agreement providing for settlement of NetBank's pending claims against an insurer of the commercial leases bought from Commercial Money Center. The settlement provided for the payment of $19.3 million to NetBank subject to court approval.

9/14/2007 NetBank receives a letter from EverBank notifying NetBank of EverBank's termination of the purchase agreement.

[23] Form 10-K is an annual report that provides a comprehensive overview of the company's business and financial condition and includes audited financial statements.

9/28/2007	OTS closes NetBank and appoints FDIC as receiver.
9/28/2007	FDIC approves assumption of the insured deposits of NetBank by ING Bank, FSB.

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness corrective actions and other issues cited in Reports of Examination (ROE)	Formal Enforcement Action
3/17/1998	2/122212	$84	**Corrective actions to be taken by NetBank** • Establish lending policies to comply with real estate standards. • Develop adequate underwriting guidelines pertaining to purchased loans and participations. • Establish a loan administration system with sufficient guidelines and controls. • Comply with Thrift Bulletin (TB) 13 requirements in Asset/Liability Management Policy. • Obtain security testing for marketing web-site. • Amend disaster plan. • Inform OTS in writing of significant changes to the budget.	None
9/8/1998	Field Visit[24]	$246	**Other issues (specific corrective action not cited in ROE)** • Concerns regarding plans to pay high rates on deposit accounts. Resulting high cost of funds may pressure management to invest in higher credit risk assets. • Purchased construction loans not properly monitored. • Error reported on a Thrift Financial Report (TFR) relating to construction loan in process commitments. • Inappropriate classification of repossessed assets.	None
5/24/1999	2/122212	$511	**Corrective actions to be taken by NetBank** • Correct deficiencies in internal asset reviews, credit administration, classification of assets, and accuracy of loan information reported on the TFR. • Develop allowance for loan and lease losses (ALLL) policies consistent with guidance and the Thrift Activities Handbook. • Conduct independent review of loan purchases. • Perform quality control checks on servicers to ensure compliance with underwriting and documentation guidelines. • Monitor compliance with written agreements and contracts with service providers and vendors. • Implement monitoring procedures for loan servicers. • Make revisions to policies and procedures as detailed on written exception sheets or in examination reports provided to management. • Develop system for tracking, analyzing, and reporting	None

[24] OTS conducted field visits of NetBank to follow-up on certain matters identified in the most recent comprehensive examination. The ROE prepared for field visits did not assign CAMELS ratings.

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness corrective actions and other issues cited in Reports of Examination (ROE)	Formal Enforcement Action
			prepayment rates of purchased loan portfolios. • Modify business plan to account for the lower amount of common equity actually raised and to reflect changes in portfolio strategies. • Adopt a formal interest rate risk (IRR) management policy in accordance with 12 CFR §563.176 and TB 13a.	
9/29/2000	2/123222	$1,535	**Corrective actions to be taken by NetBank** • Address previously cited weaknesses in lending function and monitoring of purchased loans and leases. • Develop a system for monitoring compliance with loan-to-borrower regulation. • Develop procedures for identifying and reporting loans that exceed supervisory loan-to-value ratio guidelines. • Develop IRR exposure monitoring system. • Comply with institution's policies and procedures. • Develop written ALLL policy (repeat). • Develop written procedures for annual reviews of financial statements for commercial borrowers, commercial loan guarantors, and income-producing collateral properties. • Document the review of each loan pool, prior to purchase, and underwriting criteria. • Develop a timetable and assign responsibility for correcting the deficiencies noted in ROE. • Review annually and approve all employment contracts of senior executive officers. • Prepare and present and ensure compliance with Interbank Liabilities Policy. • Review and approve the performance of the institution's appraisers annually. • Adopt written statement that addresses the risk associated with the institution's retail sales of nondeposit investment products. • Develop a system for tracking, analyzing, and reporting prepayment speeds of purchased loan portfolios. • Ensure that business plans and budgets for 2001 and beyond include detailed forecasts and projections for the thrift only. **Other issue (specific corrective action not cited in ROE)** • High turnover in key management positions.	None

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness corrective actions and other issues cited in Reports of Examination (ROE)	Formal Enforcement Action
12/11/2000	Field visit to CMC	NA	Other issue (recommendation) • Recommends that NetBank purchase no additional lease pools from Commercial Money Center (CMC) due to determination that these investments may be more risky than represented.	None
5/14/2001	Field visit (follow-up to 2000 exam)	$2,000	**Corrective actions to be taken by NetBank** • Strengthen Interbank Liabilities Policy (repeat). • Review and approve the performance of the institution's appraisers (repeat). • Develop a system for tracking, analyzing, and reporting prepayment speeds of purchased loan portfolios (repeat). • Ensure that business plans and budgets for 2001 forward have detailed forecasts and projections for thrift only.(repeat)	None
1/2/2002	2/222223	$2,867	**Corrective actions to be taken by NetBank** • Ensure all internal control deficiencies are corrected in a timely manner. • Verify funds for construction loans. • Obtain and review financial information for builders. • Develop procedures to identify all second mortgages and home equity lines of credit with combine loan-to-value ratios of 90 percent or more. • Develop procedures for identifying and documenting risks in higher risk portfolios. • Provide support for upgrading a rating of a higher risk loan. • Obtain current audited financial statements of servicers prior to entering into agreements. • Ensure documentation is maintained to permit review of all material transactions and business activities. • Monitor interest rate sensitivity. **Other issues (specific corrective action not cited in ROE)** • Tangible and core capital are below level needed to support growth. • Return on assets and return on equity were below comparable industry levels.	None

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness corrective actions and other issues cited in Reports of Examination (ROE)	Formal Enforcement Action
3/27/2003	2/222222	$3,270	**Corrective actions to be taken by NetBank** • Review and approve all automobile lending policies. • Revise construction lending policy. • Ensure sufficient funding is available before granting construction loans. • Support all construction draws with reports. • Review loan report to ensure appropriate and timely handling of all loans. • Obtain appraisals on all repossessed assets. • Conduct a property inspection and verify funds are adequate to complete construction. • Obtain and review financial information for builders. • Review all secondary market agreements for credit enhancements. **Other issue (specific corrective action not cited in ROE)** • Majority of Market Street Mortgage Corporation compensation is incentive based and tied to loan production and profitability.	None

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness corrective actions and other issues cited in Reports of Examination (ROE)	Formal Enforcement Action
7/30/2004	2/222322	$4,849	**Matters requiring NetBank board attention** • Confirm policies and procedures have been implemented for processing of Financial Crimes Enforcement Network (FinCEN) information requests. • Discuss steps to enhance compliance programs through out the company. **Corrective actions to be taken by NetBank** • Accurately report the risk-based capital calculation for Market Street Mortgage Corporation residential construction loans. • Appropriately weight the risk of firm commitments to purchase mortgage backed securities. • Properly report special mention and classified asset on TFR. • Use actual quarter-end date in ALLL analysis instead of month-old data. • Incorporate off-balance sheet instruments (sold loans) in IRR model and measure offsetting changes in loans held for sale. • Expand FinCEN searches to include records of all NetBank divisions. • Review loan application procedures for Meritage Mortgage Corporation (Meritage). • Conduct periodic fair lending statistical analysis. • Perform periodic reviews on loan pricing, underwriting, or indicators of predatory lending activities. • Establish procedures to ensure accurate reporting of Home Mortgage Disclosure Act (HMDA) information. • Provide training to lending personnel on HMDA. • Develop procedures to ensure customers receive notice are leaving the bank's insured deposit product to non-deposit investment area. • Identify and prevent deposit account fraud. **Other issues (specific corrective action not cited in ROE)** • Downgraded (from 2 to 3) earnings component rating with no corrective actions listed. • Actual net income significantly less than budget.	None

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness corrective actions and other issues cited in Reports of Examination (ROE)	Formal Enforcement Action
10/11/2005	Field Visit	Not identified	**Other issues (specific corrective action not cited in ROE)** • High level of repurchased loans requiring additional Financial Accounting Standards Board Interpretation No. 45 provisions. • Hedging activities not documented in accordance with Statement of Financial Accounting Standard (SFAS)133. • Increased competitive pressure within the mortgage industry; yield curve became flatter resulting in narrower net interest margin.	None
1/9/2006	3/323332	$4,754	**Matters requiring NetBank board attention** • Adopt a written 3-year business plan. • Provide board of directors with quarterly budget variance report. • Maintain capital levels above the well capitalized Prompt Corrective Action requirement. • Ensure that accurate regulatory capital ratios are reported in TFRs and to OTS. • Monitor regulatory capital ratios on a monthly basis. • Correct Bank Secrecy Act and Anti-Money Laundering audit deficiencies. **Other corrective actions to be taken by NetBank** • Ensure accuracy of information from systems and investors to identify off-balance sheet recourse risk for early payment default and early payoff exposure. • Improve systems to accurately identify qualifying from nonqualifying single-family mortgage loans. • Report levels of unsold nontraditional and Alternate-A mortgages to the board on a periodic basis. • Obtain current financial information and updated business licenses at NetBank Dealer Finance Services, to ensure that dealers are financially sound and complying with local laws and regulations. • Ensure that real estate owned is appropriately included in classified asset totals (repeat). • Include appropriate supporting written documentation for key assumptions used in budgeting process. • Improve operating efficiency which includes reducing expenses. • Provide and discuss quarterly written variance reports with the board of directors. • Prepare a cash flow statement on a monthly basis. • Develop written plan of action to be taken if the bank	Supervisory agreement issued 11/6/2006

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness corrective actions and other issues cited in Reports of Examination (ROE)	Formal Enforcement Action
			becomes undercapitalized. • Take action to maintain adequate capital levels. • Monitor regulatory capital levels on a monthly basis. • Report correct capital levels to OTS. • Reorganize the corporate compliance department. • Integrate compliance management on a corporate wide basis. • Leverage successful processes in other business units. • Develop compliance training. • Address observations and recommendations cited in an audit of NetBank's Bank Secrecy Act compliance program that was completed by an outside consulting firm engaged by NetBank. • Modify flood insurance procedures. • Develop procedures to monitor any third party vendors. • Complete changes mentioned in OTS exam. • Enhance statistical fair lending analysis. • Modify Meritage initial disclosure process. • Review construction lending portfolio. • Identify and evaluate risk characteristics of interest only loans. • Limit interest only and Alternate-A loan portfolios. • Ensure compliance with best practices concerning SFAS 133 requirements for hedge accounting. • Update the written SFAS 133 accounting policy related to pipeline hedge effectiveness. **Other issue (specific corrective action not cited in ROE)** • Continued diversification efforts with further leveraged capital. • Material capital reporting errors identified in reporting risk-weighted assets. Noted in prior ROE.	

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness corrective actions and other issues cited in Reports of Examination (ROE)	Formal Enforcement Action
1/3/2007	Field Visit	Not identified	**Other issues (specific corrective action not cited in ROE)** • Capital category declined from well capitalized to adequately capitalized. • Business plan adopted in response to supervisory agreement not realistic given actual operating results and current financial condition. • Federal Home Loan Bank of Atlanta increases the level of collateral requirements securing its advances to NetBank. ROE also noted a number of actions that NetBank management took between September 2006 to March 2007 to address problems. These actions included, for example, shutting down Meritage, the sale of servicing rights to $8.5 billion in mortgage loans, and termination of its auto lending operation..	None

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness corrective actions and other issues cited in Reports of Examination (ROE)	Formal Enforcement Action
3/19/2007	5/554555	$3,249	**Matters requiring NetBank board attention** • Ensure compliance with the various OTS notices and enforcement actions. • Keep reporting regulatory capital position to OTS. • Amend classification procedures for construction/ permanent loans. • Ensure proper reporting of loans in foreclosure on delinquency schedules and in classified assets. • Address concerns regarding adequacy of ALLL and FIN 45 reserve. **Other corrective actions to be taken by NetBank** • Adopt appropriate credit concentration limits for each business unit and the consolidated bank. • Ensure controls and monitoring of all existing and future credit concentrations. • Provide monthly reports on capital to OTS. • Properly report foreclosed loans on delinquency schedules and in classified assets. • Address concerns regarding ALLL and FIN 45. • Properly classify construction loans. **Other issues (specific action not required in ROE)** • Changes in market conditions for subprime products, plus managerial pressure to maintain high levels of loan production, resulting in underwriting practices being relaxed, a significant decline in the quality of loans originated and sold, and higher volumes of loan repurchases in 2006. • Underwriters previously reporting to individuals who were responsible for marketing and sales of loans.	None

Source: OIG Analysis of OTS ROEs for NetBank.

Office of Thrift Supervision
Department of the Treasury

Scott M. Polakoff
Senior Deputy Director & Chief Operating Officer

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6853

April 21, 2008

MEMORANDUM FOR: Susan L. Barron, Director, Banking Audits
Office of Inspector General,
U.S. Department of the Treasury

FROM: Scott M. Polakoff /s/
Senior Deputy Director and Chief Operating Officer

SUBJECT: Material Loss Review of NetBank, FSB
OTS Management Response to the Draft Audit Report

Thank you for the opportunity to respond to your draft audit report concerning the failure of NetBank, FSB, and the oversight responsibility of the Office of Thrift Supervision for the institution. We are in agreement with your overall findings and recommendations and appreciate the opportunity to provide the following comments.

As you are aware, OTS considers its mission of supervising thrift institutions to be critical to our nation's overall financial well being, and we are continually striving to improve and strengthen our processes. We have learned valuable lessons from the NetBank failure, as well as the other market changes that have subsequently occurred, and plan to implement your recommendations to further enhance our examination and supervisory processes.

Your draft report contains three recommended actions that I have listed below, along with OTS's plans for implementation of each:

1. Ensure that the recommendations/lessons learned from OTS's internal assessments of the NetBank failure are implemented.

   OTS Response:
   OTS's senior management team, which includes our Regional Directors, discussed the internal assessment lessons learned at our December 2007 meeting and developed strategies for implementing the lessons learned. The team will formally discuss the audit report and finalize action steps to address the recommendations during our upcoming meetings in May and June 2008. We plan on implementing the responsive actions by June 30, 2008.

Page 2

2. Re-emphasize to examiners that for 3-rated institutions, formal enforcement action is presumed warranted when the circumstances identified in the OTS Examination Handbook are met and to document the reasons when formal enforcement action is not taken.

   OTS Response:
   OTS will issue an internal staff bulletin in May 2008 re-emphasizing the current enforcement action guidance in the OTS Examination Handbook (which generally presumes formal enforcement action for 3-rated institutions) and the importance of documenting the reasons when a formal enforcement action is not pursued for a 3-rated institution. We will also discuss the importance of timely and appropriate enforcement actions during each of the five regional staff conferences scheduled during the second and third quarters of 2008.

3. Establish in policy a process to assess the causes of the failure and the supervision exercised over the institution and to take appropriate action to address any significant supervisory weaknesses or concerns identified.

   OTS Response:
   We have begun drafting an OTS policy that will require completion of a formal assessment for any future thrift failures. The assessment will include: a chronology of events leading to the failure, identification of the causes of the failure, an evaluation of the supervision exercised over the failed institution, and will provide recommendations for addressing the findings of the assessment. This new policy will be in place by May 31, 2008.

Again, thank you for the opportunity to review and respond to your draft report. We appreciated the professionalism and courtesies provided by staff of the Office of Inspector General.

cc: Director John M. Reich

Susan Barron, Director, Banking Audits
Delores Dabney, Audit Manager
Jeffrey Dye, Audit Manager
Jaideep Mathai, Auditor in Charge
Amnoiphorn Samson, Program Analyst
Michelle Littlejohn, Program Analyst
Regina Morrison, Auditor
John Gauthier, Auditor
Shiela Michel, Referencer

Department of the Treasury

Office of Strategic Planning and Performance Management
Office of Accounting and Internal Control

Office of Thrift Supervision

Office of Thrift Supervision
Liaison Officer

Office of Management and Budget

OIG Budget Examiner

United States Senate

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

U.S. House of Representatives

Chairman and Ranking Member
Committee on Financial Services

Federal Deposit Insurance Corporation

Chairman

U.S. Government Accountability Office

Comptroller General of the United States