Audit Report

OIG-11-072

SAFETY AND SOUNDNESS: Material Loss Review of Charter Bank

May 31, 2011

Office of Inspector General

Department of the Treasury

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

May 31, 2011

MEMORANDUM FOR **JOHN E. BOWMAN**
ACTING DIRECTOR
OFFICE OF THRIFT SUPERVISION

FROM: Kieu T. Rubb /s/
Audit Director

SUBJECT: Material Loss Review of Charter Bank

INTRODUCTION

The Office of Thrift Supervision (OTS) closed Charter Bank (Charter), Santa Fe, New Mexico, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on January 22, 2010. As of February 28, 2011, FDIC estimated that Charter's loss to the Deposit Insurance Fund was $246.1 million.

Under section 38(k) of the Federal Deposit Insurance Act, we are responsible for conducting a material loss review of the failure of Charter.[1] To help fulfill this responsibility, we contracted with Mayer Hoffman McCann P.C. (MHM), an independent certified public accounting firm. MHM's report dated May 24, 2011, is provided as Section I.

RESULTS OF MATERIAL LOSS REVIEW

We concur with MHM's reported conclusions regarding Charter's causes of failure and OTS's supervision of Charter.

- Charter failed primarily because of steep declines in asset quality in its commercial real estate (CRE) loan portfolio, which included concentrations in construction and land development loans. Charter's management had deepened the thrift's concentration in higher risk real estate lending even as

[1] Section 38(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, effective July 21, 2010, defines a material loss as a loss to the Deposit Insurance Fund in excess of $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar year 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met).

the local economy showed signs of weakening in 2007 and 2008 and management failed to implement adequate loan underwriting and credit administration practices. Despite its increasing construction and land development concentration, Charter remained highly leveraged and did not increase its capital so that it might weather a significant economic downturn.

- OTS's supervisory actions complied with its guidance available at the time. However, OTS did not recognize the magnitude of weaknesses in Charter's growing CRE loan portfolio and increasing concentrations in construction and land development lending until it was too late. In its September 2008 examination, OTS began to note more weaknesses in Charter's CRE loan portfolio and the effects of the recession on New Mexico. In response to these weaknesses, OTS increased its monitoring and, in February 2009, performed a limited-scope examination that focused on asset quality. In the August 2009 full-scope examination, OTS continued to find many underlying weaknesses in the CRE loan portfolio that prompted significant downgrades of credits and adjustments to the allowance for loan and lease losses. As a result, OTS's supervision of Charter did not prevent a material loss to the Deposit Insurance Fund.

Details of MHM's conclusions are contained in their report.

We also concur with MHM's reported recommendations that:

- OTS ensure that action is taken on the recommendations in the internal failed bank review for Charter that was issued August 4, 2010.

- OTS reemphasize to examiners and supervisors the importance of following sampling guidance in their reviews of non-homogeneous loans, including situations where minimum sample sizes should be increased due to the risks inherent in the loan portfolio, or the results of their loan reviews including significant downgrades to classified asset categories.

- OTS work with its regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner responses to high risk concentrations.

Please be advised that in accordance with Treasury Directive 40-03, "Treasury Audit Resolution, Follow-up, and Closure," OTS is responsible for taking corrective action on these recommendations. OTS should also record the recommendations and related actions in the Department of the Treasury's Joint Audit Management Enterprise System.

OBJECTIVES, SCOPE, AND METHODOLOGY

Under section 38 (k), we are responsible for preparing a report to OTS that (1) ascertains why Charter's problems resulted in a material loss to the Deposit Insurance Fund; (2) reviews OTS's supervision of the institution, including its implementation of the prompt corrective action provisions of section 38(k); and (3) makes recommendations for preventing any such loss in the future.

To help fulfill this responsibility, we contracted with MHM to perform a material loss review in accordance with generally accepted government auditing standards. We evaluated the nature, extent, and timing of the work; monitored progress throughout the audit; reviewed MHM-prepared documentation; met with its principals and staff; evaluated key judgments; met with OTS officials; performed independent tests of OTS supervisory records; and performed other procedures we deemed appropriate in the circumstances. We conducted our work in accordance with generally accepted government auditing standards.

Section II identifies the recipients of this report. Should you wish to discuss the report, you may contact me at (202) 927-5904.

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Section I

Mayer Hoffman McCann P.C.'s Audit Report on the Material Loss Review of Charter Bank

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Charter Bank
Material Loss Review
Safety and Soundness Performance Audit
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Abbreviations

ALLL	Allowance for Loan and Lease Losses
C&D order	Cease and Desist Order
CRE	Commercial Real Estate
FDIC	Federal Deposit Insurance Corporation
MOU	Memorandum of Understanding
MRBA	Matter Requiring Board Attention
MSR	Mortgage Servicing Rights
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
PCA	Prompt Corrective Action
ROE	Report of Examination
TFR	Thrift Financial Report

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Department of the Treasury

RE: Transmittal of Results for the Material Loss Review Report for Charter Bank, Santa Fe, New Mexico.

This letter is to acknowledge delivery of our performance audit report of the Material Loss Review for Charter Bank (Charter). The objectives of this performance audit were to: (1) determine the causes of Charter's failure and resulting material loss to the Deposit Insurance Fund and (2) evaluate the Office of Thrift Supervision's (OTS) supervision of Charter, including the implementation of the prompt corrective action (PCA) provisions of section 38 of the Federal Deposit Insurance Act.

The performance audit results are in the accompanying performance audit report. The information included in this report was obtained during our fieldwork, which occurred during the period from April 15, 2010, through June 2, 2010.

We conducted our performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

We also included several appendices to this report. Appendix 1 contains a detailed description of our material loss review objectives, scope, and methodology. Appendix 2 contains background information on Charter's history and OTS's supervision process. Appendix 3 provides a glossary of terms used in this report. The terms defined in the glossary are underlined the first time they are used in the report. Appendix 4 provides OTS's comments regarding the report's recommendations.

Mayer Hoffman McCann P.C.

Leawood, Kansas
May 24, 2011

Results in Brief

Charter's failure was primarily caused by steep declines in asset quality in its commercial real estate (CRE) loan portfolio, which included concentrations in construction and land development loans. Charter's management had deepened the thrift's concentration in higher risk real estate lending even as the local economy showed signs of weakening in 2007 and 2008 and management failed to implement adequate loan underwriting and credit administration practices as well as other practices to manage its CRE concentration risk. Despite its increasing construction and land development concentration, Charter remained highly leveraged and did not increase its capital so that it might weather a significant economic downturn. In addition, Charter maintained a large mortgage operation that, while historically providing positive net income, contributed to the thrift's volatility in earnings and capital ratios.

OTS's supervision of Charter did not prevent an estimated material loss of $246.1 million[1] to the Deposit Insurance Fund. OTS did not recognize the magnitude of weaknesses in Charter's growing CRE loan portfolio and increasing concentrations in construction and land development lending until it was too late. OTS commented in the June 2007 examination on the thrift's increasing risk profile due to higher volumes of construction lending, lot lending, and CRE lending. However, these comments regarding risk exposure were minimized by other OTS conclusions in the same examination report that asset quality was satisfactory, capital was maintained at an adequate level commensurate with Charter's risk profile, and management was satisfactorily managing concentration risks. Consequently, the June 2007 examination missed opportunities to address the thrift's growing concentration risks in construction, land development, and CRE loans.

In its September 2008 examination, OTS began to note more weaknesses in Charter's CRE loan portfolio and the effects of the recession on New Mexico. In response to these weaknesses, OTS increased its monitoring and, in February 2009, performed a limited-scope examination that focused on asset quality. In the August 2009 full-scope

[1] The loss estimate is as of February 28, 2011.

examination, OTS continued to find many underlying weaknesses in the CRE loan portfolio that prompted significant downgrades of credits and adjustments to the allowance for loan and lease losses (ALLL). The adjustments ultimately resulted in Charter being critically undercapitalized and later failing.

OTS examiners did not follow OTS sampling guidance for their review of non-homogeneous loans. Many of the underwriting weaknesses in the CRE loan portfolio were identified in the September 2008 examination, but the scope of the loan review was not increased in response to higher risks and the full extent of the weaknesses were not identified until the August 2009 examination.

Charter had a strategy of operating the thrift at a highly leveraged position and conducting higher risk lending activities, particularly in its construction and land development lending. Higher risk activities generally require more capital, especially if the activities are conducted at significant concentration levels. OTS appropriately directed Charter to increase capital levels in response to heightened risk noted in the September 2008 examination. However, earlier examinations should have placed more emphasis on Charter's growing concentration risk and weaknesses in its risk management policies and procedures to manage those concentration risks including an assessment of capital adequacy.

An internal OTS review determined that Charter's failure was caused by excessive concentration in construction and land development loans, deterioration in asset quality caused by the downturn in the national economy, and inadequate capital levels. Regarding supervision, the review found that the thrift's capital deficiency with respect to its concentration risk was not properly evaluated, opportunities to curtail growth in higher risk assets and impose higher minimum capital requirements were missed, and risks posed by increasing levels of higher risk loans and management's high leverage strategies were not adequately addressed. The OTS review recommended that: 1) examination and supervisory staff should impose higher capital requirements and/or require prudent limits for higher risk lending concentrations and 2) for thrifts with relatively high levels of concentration risk, examination and regulatory staff should evaluate management's contingency plan to reduce or mitigate the concentration risk in the event of adverse market conditions.

Our material loss review affirms the findings and recommendations of OTS's internal review. Excessive concentrations of higher risk loans were clearly a major cause of failure and examiners did not have clear guidance on what levels of concentrations posed unsafe and unsound levels.

Recommendations

We are recommending that OTS: 1) Ensure that action is taken on the recommendations made in the OTS failed thrift institution review of Charter; 2) Reemphasize to examiners the importance of following sampling guidance on its review of non-homogeneous loans, including situations where minimum sample sizes should be increased for risks inherent in the loan portfolio or the results of its loan reviews include significant downgrades to classified asset categories; and 3) Work with its regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high risk concentrations.

<u>Management Response</u>

As recommended in previous failed bank reviews, OTS has issued additional examination guidance to staff to impose higher capital requirements and/or require prudent limits for higher risk lending concentrations. OTS agrees with our recommendation to reemphasize to examiners and supervisors the importance of following sampling guidance. OTS issued CEO Letter 311 in July 2009 to address increased regulatory scrutiny for concentration risk management. Additionally, OTS supports all opportunities to promote safe and sound business practices on an inter-agency basis and will continue to work with the other federal agencies until the implementation of the Dodd-Frank Act transfers OTS responsibilities to other respective federal banking agencies.

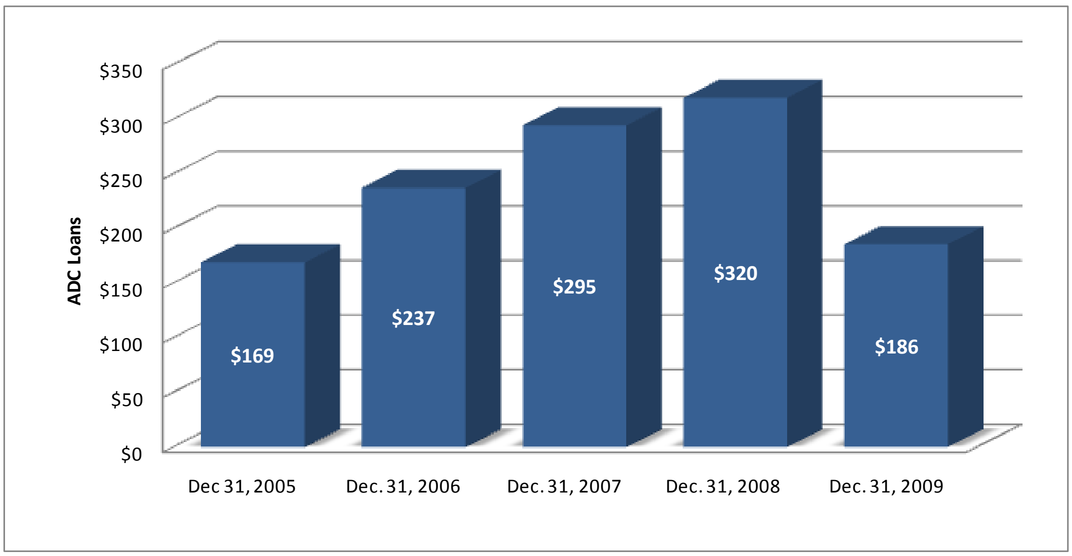
We included management's response in its entirety as Appendix 4.

Causes of Charter's Failure

Concentration in Construction and Land Development Loans During the Real Estate Downturn

Charter historically focused on real estate lending primarily in its home state of New Mexico. At the beginning of the nationwide real estate downturn in 2007, the thrift increased its exposure to real estate by growing both its 1-4 family owner-occupied and higher risk construction and land development loan portfolios. From December 31, 2006, to December 31, 2008, Charter's construction and land development loan portfolio increased about 35 percent, or $83 million, as shown in Figure 1.

Figure 1. Growth in Construction and Land Development Loan Portfolio (in millions)



Source: Analysis from the Federal Deposit Insurance Corporation (FDIC) Statistics on Depository Institutions.

Charter's growth in its construction and land development loan portfolio resulted in a concentration in higher risk lending. In December 2006, OTS issued CRE guidance (2006 CRE Guidance) to clarify to its examiners that institutions actively engaged in CRE lending should: (1) assess their concentration risk and (2) implement appropriate risk management policies to identify, monitor, manage, and control their concentration risks.[2] The 2006

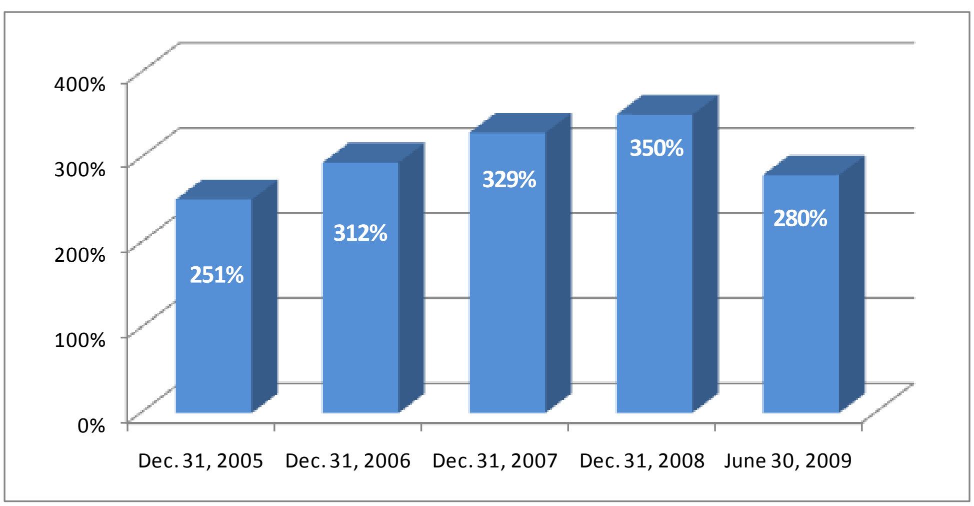
[2] OTS, Guidance on Commercial Real Estate (CRE) Concentration Risks, December 14, 2006.

CRE Guidance used certain criteria to identify thrifts that may have CRE concentration risk. These include thrifts that:

- Have CRE loans approaching the statutory limit for loans secured by nonresidential properties of 400 percent of total capital;[3]
- Have experienced rapid growth in CRE lending;
- Have notable exposure to a specific type of or high-risk CRE;
- Were subject to supervisory concern over CRE lending during preceding examinations; or
- Have experienced significant levels of delinquencies or charge-offs in their CRE portfolio.

As Figure 2 illustrates, the thrift's pursuit of construction and land development loans from 2005 through 2008 served to heighten its risk profile. In both 2007 and 2008, construction and land development loans were approaching the statutory limit for loans secured by nonresidential properties of 400 percent of total capital. The portfolio also experienced rapid growth from 2005 to 2008, and had notable exposure in the higher risk construction and land development loans segment of CRE loans.

Figure 2. Construction and Land Development Loans as a Percent of Risk Based Capital



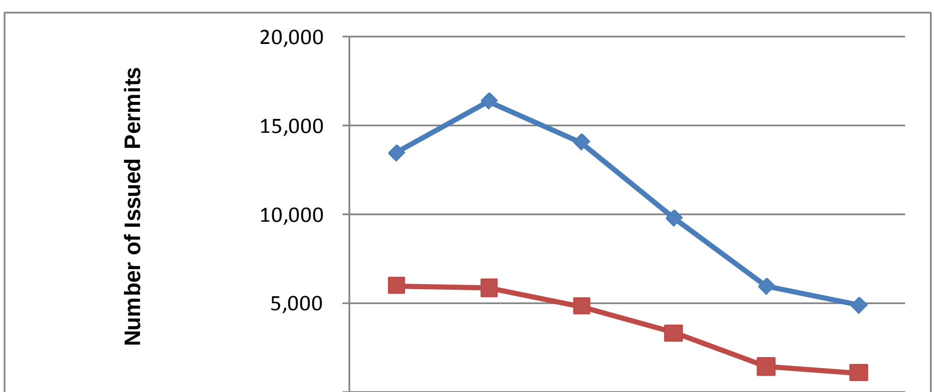
Source: Analysis from FDIC Statistics on Depository Institutions.

[3] 12 U.S.C. 1464(c)(2)(B).

While Charter's management pursued higher risk loans, it failed to manage the risks associated with its CRE concentrations. While Charter did participate in CRE loans outside of its home state, a majority of the thrift's exposure was confined to the Albuquerque and Santa Fe metropolitan areas. Board of director minutes documented that management and board members were aware of the national real estate downturn affecting surrounding states in 2007 and 2008; however, they believed New Mexico's economy was fundamentally sound and that any real estate downturn would be short-lived and mild.

Even though New Mexico lagged neighboring states in entering the recession, economic data showed warning signs as early as 2007 that the state would experience similar declines in its real estate industry. Figure 3 shows the peak in 2005 and subsequent declines in later years for the number of building permits issued for single and multi-family residences in New Mexico and the combined Albuquerque and Santa Fe area. The severity of the downturn is illustrated by the fact that the number of building permits issued in the state dropped 10,405, or 64 percent, between 2005 and 2008. As illustrated in Figure 1, Charter continued to increase its construction and land development loan portfolio during the same time period. The fact that builders were applying for fewer building permits should have been a red flag to Charter to decrease its exposure to construction and land development loans.

Figure 3. Building Permits Issued in New Mexico



	2004	2005	2006	2007	2008	2009
All of New Mexico	13,436	16,363	14,063	9,788	5,958	4,890
Albuquerque and Santa Fe	5,993	5,862	4,834	3,322	1,437	1,082

Source: Bureau of Business and Economic Research, University of New Mexico.

Inadequate Capital Levels for Risk Profile

As early as the August 2003 examination, OTS recommended that Charter increase its capital ratios in order to ensure that the thrift could sustain significant volatility in its earnings. In 2003, Charter agreed to maintain Tier 1 (core) leverage capital and risk-based capital ratios of 5.25 and 10.25 percent which were just above the minimum amounts of 5 and 10 percent to be considered well-capitalized under the prompt corrective action framework for insured institutions. Although OTS examiners repeatedly recommended increasing capital in their next two full-scope examinations in 2004 and 2006, they did not require the thrift to maintain higher capital until the September 2008 examination when OTS issued a matter requiring board attention (MRBA) directing a core capital ratio of 7.5 percent and a risk-based capital of 12 percent.

Historically, Charter had a strategy of operating the thrift at a highly leveraged position and maintaining capital at minimum levels required to be well-capitalized as shown in Table 1.

Table 1. Charter's Capital Ratios

Regulatory Capital Ratios								
Year	2006		2007		2008		2009	
	Tier 1 Leverage	Total Risk Based	Tier 1 Leverage	Total Risk Based	Tier 1 Leverage	Total Risk Based	Tier 1 Leverage	Total Risk Based
Charter	6.08	12.54	6.01	10.96	5.98	10.43	6.80	11.55
Required to be "Well Capitalized"	5.00	10.00	5.00	10.00	5.00	10.00	5.00	10.00

Source: Analysis from FDIC Statistics on Depository Institutions. Years 2006 through 2008 as of December 31. Year 2009 as of June 30.

Charter responded to OTS's capital recommendations stating that the thrift's capital position complimented the board's strategy of maximizing return on equity. Also, because Charter was organized as an S Corporation, dividends needed to be paid to stockholders so that they could meet their individual tax liabilities associated with the pass-through of the thrift's earnings. In our discussions with the OTS Regional Director, he noted how difficult it is for S Corporation thrifts to raise capital from outsiders because of the restrictions on the types and numbers of stockholders. On November 1, 2009, Charter converted from an S

Corporation to a C Corporation in its efforts to attract outside capital. Despite its conversion, Charter's efforts to attract outside capital were ineffective.

When the board agreed to maintain core capital of 5.25 percent and risk-based capital of 10.25 percent in 2003, it also agreed to conduct periodic reviews of risk factors that might threaten the thrift's capital position. During such a review in February 2007, the board noted that in addition to the volatility of the valuation of the thrift's mortgage servicing rights (MSR) asset, carried at approximately $34 million as of December 31, 2006, the thrift had recently assumed additional risks in originating non-prime loans and lending concentrations in CRE. Even though additional risks were noted, the board concluded that maintaining the minimum capital amounts to be considered well-capitalized was appropriate. The board and management believed that as long as Charter attained the well-capitalized ratios under the PCA framework, then by definition, the thrift's capital was adequate. Contrary to Charter's position, the 2006 CRE Guidance reminded thrifts to hold capital commensurate with the level and nature of their risks. Specifically, the 2006 CRE Guidance suggests that institutions with inadequate capital to serve as a buffer against unexpected losses from CRE concentrations should develop plans to either reduce CRE concentrations or raise capital. Charter did neither.

To fund Charter's construction and land development concentrations, management leveraged the balance sheet with wholesale funding, including brokered deposits and Federal Home Loan Bank (FHLB) advances. Charter's reliance on non-core deposits increased its liquidity risk. As the thrift's capital levels fell to below well-capitalized, Charter could not accept or renew brokered deposits without specific approval from the FDIC. As its financial condition further worsened, Charter could not borrow additional funds from the FHLB without additional collateral.

Inadequate Loan Underwriting and Credit Administration Practices Led to Increase in Adversely Classified Assets

In the 2008 full-scope examination, OTS examiners noted significant deterioration in asset quality due to Charter's high level of credit risk associated with its construction and land development lending program. In both its 2008 full-scope and 2009 limited-scope examinations, OTS examiners cited inadequate loan underwriting and credit administration practices that led to an increase in adversely classified assets. The examinations focused on Charter's largest construction and land development loans. The examiners cited deficiencies in the following areas:

- Asset Classification
- Impairment Analysis
- Loan Modification

During the 2009 examination, OTS downgraded several loans from special mention to substandard and identified instances where Charter's impairment analysis for impaired loans was improper. Examiners were particularly concerned with a practice where construction loan extensions that only changed the maturity date were not documented through formal extension or "change in terms" agreements. The decision by management to not request formal extensions was based on a clause in the construction promissory notes which read, "In the event the improvements are not completed within the initial loan terms, and a principal balance remains outstanding on the day following the original maturity date, the borrower agrees and consents to one or more extensions of the maturity date."[4] The examiners were concerned that this practice may be used to extend problem loans without an assessment of the borrower's ability to repay the loan.

This limited-scope examination began August 10, 2009, and concluded on August 26, 2009. The examination identified issues that prompted OTS to open a comprehensive full-scope examination the following day. As part of the new examination, examiners downgraded a significant number of problem credits that were not previously classified by Charter. In the June 2009 Thrift Financial Report (TFR), the thrift reported $98.1 million in substandard assets. However,

[4] August 2009 Report of Examination.

as a result of the OTS downgrades, Charter reported substandard assets of $159.4 million in its September 2009 TFR, which represented 252 percent of core capital plus the ALLL.

The significant downgrades called into question the effectiveness of Charter's asset classification system. In addition, the practice of automatically granting loan extensions for construction loans significantly masked problems developing in the construction and land development loan portfolio for stalled development projects or for completed construction projects that were not selling.

Mortgage Operations Division Contributed to Volatility in Earnings and Capital Levels

Charter maintained a mortgage operations division responsible for originating single family loans that were generally sold with servicing rights retained by the thrift. When the mortgage division sold these loans, the thrift recorded a gain on the expected servicing revenue upon sale of the loans and capitalized the amount as MSR. Until 2009, Charter amortized the MSR asset over the expected lives of the underlying loans and reviewed the asset for impairment at least annually. The asset value, which was reported as high as $36 million in 2007, could be unstable because its fair value was influenced by variables that could change frequently, including national mortgage rates, credit quality of borrowers, and estimated pre-payments. As early as 2003, OTS encouraged Charter to retain more capital to cushion the thrift against negative fluctuations in the MSR asset. In 2008, Charter recorded a $9.7 million impairment charge as the asset's estimated fair value was lower than its amortized cost.

The mortgage operations division also originated and purchased sub-prime loans, which were also sold to investors. In 2004, Charter opened mortgage production offices in Idaho and Colorado that originated sub-prime loans in various regions of the United States. By the time Charter closed its sub-prime line of business in September 2008, 56 percent of the sub-prime loan portfolio was collateralized by property in Florida where real estate values were rapidly declining. In 2009, the thrift recorded a fair value impairment charge of $11 million on its sub-prime loan portfolio.

OTS's Supervision of Charter

OTS's supervision of Charter did not prevent an estimated material loss of $246.1 million to the Deposit Insurance Fund. OTS did not recognize the magnitude of weaknesses in Charter's growing CRE loan portfolio and increasing concentrations in construction and land development lending until it was too late. Charter had a strategy of operating the thrift at a highly leveraged position. Examinations from 2003 through 2007 generally acknowledged this strategy, but OTS failed to require Charter to increase its capital levels to compensate for the risk until its September 2008 examination. In this examination, OTS began to see weaknesses increasing in Charter's CRE loan portfolio and the effects of the recession on New Mexico. In the August 2009 examination, OTS found many underlying weaknesses in the CRE loan portfolio that prompted significant downgrades of credits and adjustments to the ALLL. The adjustments ultimately resulted in Charter being critically undercapitalized and later failing.

OTS's Supervisory History and Actions

Table 2 summarizes the results of OTS's safety and soundness and limited examinations from 2003 until its closure.

Table 2. Summary of OTS's Examinations and Enforcement Actions

Date Started/ Date Completed	Examination Type	CAMELS Rating	Number of MRBAs	Number of Corrective Actions	Informal/Formal Enforcement Actions
8/25/2003 10/30/2003	Full-scope	2/222112	2	13	None
11/1/2004 1/19/2005	Full-scope	2/222222	2	8	None
3/6/2006 5/8/2006	Full-scope	2/222222	None	None	None
6/25/2007 8/18/2007	Full-scope	2/222222	None	None	None
9/15/2008 11/7/2008	Full-scope	3/332222	9	9	Memorandum of understanding (MOU) 3/4/2009 (informal enforcement action)
3/30/2009 3/30/2009	Limited-scope	3/343222	None	None	None
8/10/2009 8/26/2009	Limited-scope	4/444332	None	None	Cease and desist order (C&D order) 11/20/2009 (formal enforcement action)
8/27/2009 12/3/2009	Full-scope	5/555555	None	16	None
10/27/2009 11/2/2009	Limited-scope	5/555554	None	None	None

Source: OTS's Report of Examinations (ROEs) and enforcement actions.

OTS Did Not Take Timely Action to Address Unsafe Concentrations in High Risk Lending Areas

The thrift was building up CRE concentrations that were identified as high risk in the 2006 CRE Guidance. OTS commented in the June 2007 examination on the thrift's increasing risk profile due to higher volumes of construction lending, lot lending, and CRE lending. However, these comments regarding risk exposure were minimized by other OTS conclusions in the same examination report that asset quality was satisfactory and capital was maintained at an adequate level commensurate with Charter's risk profile. With respect to concentrations, the June 2007 examination concluded that management was satisfactorily identifying, monitoring, controlling, and reporting to the board the thrift's concentration risks.

The June 2007 examination missed opportunities to address the thrift's growing concentration risks in construction and land development loans. This examination's conclusions were also inconsistent with the 2006 CRE Guidance. OTS did not formally address CRE concentrations with Charter until it issued a letter to the thrift on July 17, 2009, addressing guidance in OTS's CEO Letter 311.[5] The letter identified concentrations of credit risk in construction, land, and non-residential mortgage loans. OTS notified Charter that the board must support and justify the safety and soundness of Charter's concentrations of credit risks in the current environment and to reevaluate the thrift's concentration risks. Charter was to provide OTS with the results of their review with respect to these matters and the steps taken by the board to reduce and manage the concentration risks. The July 17, 2009, communication from OTS on CRE concentrations was too late to address the concentrations which had already elevated the thrift's non-performing assets and were a major source of examination concerns in the August 2009 examination.

Had OTS examiners followed guidance contained in the 2006 CRE Guidance in the June 2007 examination, we believe examiners would have noted exceptions in that examination and directed Charter to assess its CRE concentration exposure and establish risk management policies and procedures to address the concentration risks. In the September 2008 examination, the examiners reacted to growing problem assets by placing additional requirements on capital levels, and issuing several MRBAs concerning asset quality. The focus of the September 2008 exam was to address problem assets rather than making recommendations concerning the effectiveness of risk management practices over CRE concentration risk.

OTS Did Not Follow Its Sampling Guidance for the Review of Non-Homogeneous Loans

OTS did not follow its sampling guidance for its review of non-homogeneous loans in the June 2007 and September 2008 examinations. In the August 2009 examination, OTS significantly increased the scope of its review of non-homogeneous loans compared to the loans reviewed in the prior two examinations and found many underlying weaknesses in the non-homogeneous loan portfolio that

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[5] Chief Executive Officer (CEO) Letter No. 311, Risk Management: Asset and Liability Concentrations (July 9, 2009).

prompted significant downgrades of credits and adjustments to the ALLL. The adjustments ultimately resulted in Charter being critically undercapitalized and later failing. Table 3 summarizes the percentage of the non-homogeneous loan portfolio reviewed by OTS in each examination.

Table 3. Percentage of Non-Homogeneous Loans Reviewed

6/25/2007		21%
9/15/2008		27%
8/10/2009		63%
Source: OTS Examination workpapers.		

The OTS Examination Handbook states that the combined sequential and independent samples should, at a minimum, total 30 percent to 50 percent of the aggregate dollar volume of non-homogeneous assets. The 30 percent minimum should be used only where risk is minimal and conditions ideal, such as thrifts with excellent policies and controls, a history of no significant asset quality problems, and little recent growth.[6]

Based on OTS sampling guidance, a minimum scope for loan review in the June 2007 and September 2008 examinations should have been 30 percent at the outset of the examination. Many of the credit underwriting and administration deficiencies noted in the August 2009 examination were evident in the September 2008 examination and, in retrospect, warranted increasing loan review scope above the minimum scope. Had a larger scope for loan review been performed in the September 2008 examination, the underwriting weaknesses in the CRE loan portfolio likely would have resulted in higher levels of adversely classified assets in that examination.

In the September 2008 examination, OTS downgraded approximately $10 million in loans from “pass” or special mention to substandard. As a result, substandard loans comprised 61 percent of capital plus ALLL.

[6] OTS Examination Handbook, section 209.

In our discussions with the examiner-in-charge for the 2008 examination, he stated that examination resources were scarce during this examination. While he was surprised that the examiners' review fell slightly short of the 30 percent minimum sampling coverage, he stated that he simply did not have the necessary resources to increase the loan review scope beyond the 27 percent; even though he stated that the risks in the portfolio would have justified a larger scope. OTS issued a memorandum of understanding (MOU) dated March 4, 2009, to address the concerns raised in the September 2008 examination. In addition, OTS performed a limited-scope examination in February 2009 that focused on asset quality. This examination resulted in a downgrade of the CAMELS rating for the asset quality component from a 3 to a 4.

It was not until the August 2009 examination that OTS concluded that Charter had inaccurately reported problem assets, had inadequate reserves, and reported inflated earnings and an overstated capital position. Consequently, OTS mandated adjustments which ultimately resulted in Charter being undercapitalized. This action also prompted PCA.

OTS Did Not Require Additional Capital Early Enough to Compensate for Higher Risk Activities

OTS Examination Handbook, section 120 outlines considerations for capital adequacy. The various OTS capital requirements assume that a thrift primarily engages in traditional, relatively low risk activities. Higher risk activities require more capital, especially if the activities are conducted at significant concentration levels.

Charter had a strategy of operating the thrift at a highly leveraged position. Examinations from 2003 through 2007 generally acknowledged this strategy, but OTS did not cite this as a concern or require increased capital levels to compensate for growing concentrations in higher risk loans. OTS examiners told us that as long as Charter was well-capitalized, they did not have the ability to require more capital. However, under existing OTS examination guidance, examiners should encourage more capital in response to higher risk activities. Therefore, OTS examiners could have done more to ensure the safety and soundness of Charter.

OTS did not direct Charter to increase capital levels in response to heightened risk until the September 2008 examination, when the extent of asset quality problems became evident to examiners. The September 2008 examination, in response to high levels of classified assets, included an MRBA that Charter maintain a Tier 1/risk-based capital ratio of 7.5 percent and a total risk-based capital ratio of 12 percent from March 31, 2009, until December 31, 2009, with increases to 8 percent and 12.5 percent after December 31, 2009. Charter was unable to achieve these capital levels.

OTS Enforcement Actions

OTS took the following enforcement actions against Charter.

- As previously stated, on March 4, 2009, OTS issued an MOU, an informal enforcement action, to address unsafe and unsound practices and conditions at Charter, such as its precarious capital position and deteriorating asset quality, identified during the full-scope examination that began in September 2008. Among other things, the MOU required the thrift to achieve and maintain a Tier 1/risk-based capital ratio of 6.25 percent and a total risk-based capital ratio of 11 percent by June 30, 2009, with increases to 6.5 percent and 11.5 percent at December 31, 2009, rather than the minimum requirements of 6 percent and 10 percent, to be PCA well-capitalized.[7] The capital levels set forth in the MOU were less than the capital levels prescribed in the September 2008 OTS examination. These levels were a result of Charter's capital ratios dropping in December 2008 due to recognition of a large impairment in the value of MSR. After the impairment recognition, OTS agreed to adjust the capital ratio targets. Regardless, Charter was unable to achieve the lower capital levels prescribed by the MOU.

[7] The MOU also required the thrift to (1) submit a 2-year capital plan by March 31, 2009; (2) submit quarterly variance reports and monthly liquidity reports; (3) refrain from accepting new brokered deposits without OTS written approval; (3) refrain from capital distributions without OTS written approval; (4) revise its asset classification policy and submit quarterly ALLL reports; (5) submit quarterly reports on the status of classified assets; (6) submit impairment analysis procedures and obtain quarterly appraisals on all real estate loans with balances greater than $1 million and appraisals more than one-year old; (7) adopt and submit a loan modification policy; and (8) obtain a third-party loan review report of all construction, construction and land development, permanent land and nonresidential real estate, and commercial loans with balances greater than $50,000.

- On November 4, 2009, OTS issued a liquidity directive directing the thrift to take all necessary steps to increase funding sources. This directive was in response to Charter becoming critically undercapitalized, which subjected the thrift to further lending restrictions by the Federal Home Loan Bank of Dallas and the Federal Reserve Bank of Kansas City.

- On November 20, 2009, OTS executed a Stipulation and Consent to the issuance of a C&D order in response to its limited-scope examination of October 27, 2009, which downgraded Charter's composite CAMELS rating to 5. The C&D order required Charter to achieve and maintain a Tier 1/risk-based capital ratio of 4 percent and a total risk-based capital ratio of 8 percent by December 31, 2009.[8]

PCA Was Taken by OTS as Charter's Capital Levels Fell

The purpose of PCA is to resolve the problems of insured depository institutions with the least possible long-term loss to the Deposit Insurance Fund.[9] PCA provides federal banking agencies with the authority to take certain actions when an institution's capital drops to certain levels. PCA also gives regulators flexibility based on criteria other than capital to help reduce deposit insurance losses caused by unsafe and unsound practices. OTS took the following PCA actions against Charter:

- On October 23, 2009, OTS issued a PCA Notification notifying Charter that the thrift was deemed to be undercapitalized based on information obtained during the August 27, 2009, examination. Consequently, OTS directed the thrift to file a capital restoration plan by November 9, 2009, and comply with mandatory

[8] The C&D order also required the thrift to (1) submit a capital augmentation plan by November 30, 2009, outlining plans for achieving the capital levels including consideration of different scenarios based on asset quality and anticipated timeline for raising capital; (2) submit daily liquidity reports; (3) evaluate and classify its assets and establish ALLL in accordance with regulations and OTS guidance; (4) submit a CRE concentration report by November 30, 2009; (5) limit asset growth; (6) not accept brokered deposits; (7) not make any capital distributions without OTS written approval; (8) not make prohibited severance and indemnification payments; (9) notify OTS of any changes in its directors and senior officers; (10) not make any changes in employment contracts and compensation agreements without OTS approval; (11) not enter into contracts outside the normal course of business; and (12) not enter any new transactions with affiliates.

[9] 12 U.S.C. Sec. 1831o and 12 C.F.R. Sec. 6.

restrictions on undercapitalized institutions set forth in 12 U.S.C. Section 1831o.

- On October 29, 2009, OTS issued a PCA Notification notifying Charter that the thrift was deemed to be critically undercapitalized after OTS directed Charter to record an additional $65.2 million to the ALLL provision. As a result, OTS directed the thrift to file a capital restoration plan by November 9, 2009, and comply with mandatory restrictions on critically undercapitalized institutions set forth in 12 U.S.C. Section 1831o. The capital restoration plan required a description of the steps Charter would take to correct the unsafe or unsound condition or practice, and required performance guarantees by each company that directly or indirectly controlled the thrift. Charter filed a capital restoration plan on November 9, 2009. OTS rejected the plan on November 24, 2009, after concluding that it would not adequately capitalize the thrift in a reasonable amount of time.

- On January 20, 2010, OTS issued a PCA Directive requiring Charter to address the thrift's failure to maintain at least adequately capitalized status as defined in 12 C.F.R. Section 565.5. The PCA Directive required the thrift to be recapitalized by an acquisition by another financial institution or holding company, the sale of substantially all assets and liabilities, or a cash capital infusion and reach adequately capitalized status within 30 days after the effective date of the directive.

We concluded that OTS appropriately implemented PCA as Charter's capital levels fell below adequately capitalized. The PCA actions taken, however, did not prevent the thrift's failure.

OTS Failed Thrift Institution Review

In accordance with OTS policy, an internal review of Charter's failure was performed to determine the causes of the failure, evaluate the supervision exercised by OTS, and provide recommendations based upon the findings of the review.[10] The OTS review determined that Charter's failure was caused by excessive concentration in higher risk loans, primarily construction and land development loans, deterioration in asset quality caused by the downturn in the national economy, and inadequate capital levels.

Regarding supervision, the review found that:

- The thrift's capital deficiency with respect to its concentration risk was not properly evaluated.
- Opportunities to curtail growth in higher risk assets and impose higher minimum capital requirements were missed.
- Risks posed by increasing levels of higher risk loans and management's high leverage strategies were not adequately addressed.

The OTS report made the following recommendations:

1. Examination and supervisory staff should impose higher capital requirements and/or require prudent limits for higher risk lending concentrations.
2. For thrifts with relatively high levels of concentration risk, examination and regulatory staff should ascertain, evaluate, and document management's contingency plan to reduce or mitigate the concentration risk in the event of adverse market conditions. Regulatory staff should consistently and carefully consider management's ability to execute plans under less than satisfactory market conditions.

[10] OTS policy requires that an internal assessment be conducted when a thrift fails. That assessment, referred to as a failed thrift institution review, is performed by staff independent of the region responsible for supervisory oversight of the failed thrift. The report is reviewed and signed by OTS's deputy director of examinations, supervision, and consumer protection. OTS's Southeast Region initiated an internal review of Charter following its failure in January 2010. The scope of the review focused primarily on OTS's supervision from November 2004 to January 2010.

Our material loss review affirms the findings and recommendations of OTS's internal review. Excessive concentrations of higher risk loans were clearly a major cause of Charter's failure.

Recommendations

As a result of our material loss review of Charter, we recommend that OTS do the following:

1. Ensure that action is taken on the recommendations made in the OTS failed thrift institution review for Charter that was issued August 4, 2010.

   Management Response
   OTS responded that in reaction to other failed bank reviews, it has issued additional examination guidance to staff to impose higher capital requirements and/or require prudent limits for higher risk lending concentrations. Also, since May 2008, OTS has issued a variety of examiner guidance bulletins addressing lessons learned from previous internal failed bank reviews.

   Mayer Hoffman McCann P.C. Comment
   The implementation of the recommendation is the responsibility of OTS management.

2. Reemphasize to examiners and supervisors the importance of following sampling guidance in their reviews of non-homogeneous loans, including situations where minimum sample sizes should be increased due to the risks inherent in the loan portfolio, or the results of their loan reviews including significant downgrades to classified asset categories.

   Management Response
   OTS agreed with our recommendation.

   Mayer Hoffman McCann P.C. Comment
   The implementation of the recommendation is the responsibility of OTS management.

3. Work with its regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for concentrations that

pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high risk concentrations.

Management Response

OTS responded that it issued CEO Letter 311 in July 2009 addressing increased regulatory scrutiny for concentration risk management, including requiring board established limits and controls. The letter communicated that OTS will pursue appropriate corrective action or enforcement action when an institution does not maintain appropriate concentration limits or takes excessive risks. In addition, OTS supports all opportunities to promote safe and sound business practices on an inter-agency basis until the implementation of the Dodd-Frank Act that transfers OTS responsibilities to other respective federal banking regulatory agencies.

Mayer Hoffman McCann P.C. Comment

The implementation of the recommendation is the responsibility of OTS management.

We performed a material loss review of the failure of Charter Bank (Charter) under contract with the Department of the Treasury Office of Inspector General (Treasury OIG). Our objectives were to determine the causes of Charter's failure and assess its supervision by the Office of Thrift Supervision (OTS). At the time of Charter's failure on January 22, 2010, the Federal Deposit Insurance Corporation (FDCI) estimated that the loss to the Deposit Insurance Corporation was $201.9 million. As of February 28, 2011, FDIC revised its initial estimated loss to the Deposit Insurance Fund to $246.1 million. FDIC also estimated that Charter's failure resulted in a loss of $304,000 to its Transaction Account Guarantee Program.

Our material loss review of Charter was conducted in response to section 38(k) of the Federal Deposit Insurance Act.[11] This section provides that if the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the inspector general for the appropriate federal banking agency is to prepare a report to the agency that:

- ascertains why the institution's problems resulted in a loss to the insurance fund;
- reviews the agency's supervision of the institution, including its implementation of the prompt corrective action (PCA) provisions of section 38 (k); and
- makes recommendations for preventing any such loss in the future.[12]

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

To accomplish our review, we conducted fieldwork at OTS's headquarters in Washington, D.C. and its Western Region Office in Irving, Texas. We also interviewed officials at the FDIC's Division of Supervision and Consumer Protection in Dallas, Texas, and conducted interviews of OTS personnel who worked on the thrift's examinations

[11] 12 U.S.C. § 1831o(k).
[12] At the time of Charter's failure, section 38(k) defined a material loss as a loss to the Deposit Insurance Fund that exceeded the greater of $25 million or 2 percent of the institution's total assets. Amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, effective July 21, 2010, section 38(k) now defines a material loss as a loss to the Deposit Insurance Fund in excess of $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar year 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met).

and supervision. We also reviewed thrift records at the FDIC Division of Resolution and Receivership in Irvine, California. We conducted our fieldwork from April 2010 through June 2010.

To assess the adequacy of OTS's supervision of Charter, we determined (1) when OTS first identified Charter's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OTS took to get the thrift to correct the problems. We also assessed whether OTS (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we performed the following work:

- We determined that the time period relating to OTS's supervision of Charter covered by our audit would be from January 1, 2003, through the thrift's failure on January 22, 2010. This period included five full-scope safety and soundness examinations prior to OTS's March 2009 designation of Charter as a trouble institution and three limited-scope examinations.

- We reviewed OTS's supervisory files and records for Charter from November 2004 through January 2010. We analyzed examination reports, supporting work papers, 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 OTS used to compel thrift management to address deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers other than those incidentally available through the supervisory files.

- We interviewed and discussed various aspects of the supervision of Charter with OTS officials and examiners to obtain their perspectives on the thrift's condition and the scope of the examinations.

- We interviewed FDIC officials responsible for monitoring Charter for federal deposit insurance purposes.

- We selectively reviewed Charter documents that had been taken by FDIC and inventoried by FDIC Division of Resolutions and Receiverships personnel.

- We assessed OTS's actions based on its internal guidance and requirements of the Federal Deposit Insurance Act.[13]

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[13] 12 U.S.C. § 1811 et seq.

History of Charter Bank

Charter Bank (Charter) was chartered in September 1986 as a savings association in Santa Fe, New Mexico. The thrift was wholly owned by a one-bank holding company, Charter Companies, Inc., whose common stock was owned and controlled by a single family. At its largest, Charter operated eight full-services branches in New Mexico and maintained loan production offices in New Mexico, Idaho, and Colorado. Charter failed on January 22, 2010, as a result of holding excessive concentrations in CRE loans during a downturn in the national economy exacerbated by a strategy of maintaining inadequate capital levels for its risk profile. In addition, the thrift's mortgage operations division contributed to the thrift's earnings volatility.

Types of Examinations Conducted by OTS

OTS conducts various types of examinations, including safety and soundness, compliance, and information technology. Table 4 shows the number of OTS staff hours spent examining Charter from 2004 to 2009.

Table 4: Number of OTS Hours Spent on Examining Charter, 2004-2009

Examination Start Date	Number of Examination Hours*
11/1/2004	1,227
3/6/2006	908
6/25/2007	921
9/15/2008	1,592
3/30/2009	1,545
Total	**6,193**

Source: OTS.
*Hours are totaled for safety and soundness, compliance, and information technology examinations.

OTS must conduct full-scope examinations of insured thrifts either once every 12 months or once every 18 months, depending on the size of the thrift and other factors. Charter was on a 12-month cycle. During a full-scope examination, examiners conduct an onsite examination and rate all CAMELS components. OTS then assigns the thrift a

CAMELS composite rating based on its assessment of the thrift's overall condition and OTS's level of supervisory concern.

Enforcement Actions Available to OTS

OTS performs various examinations of thrifts that result in the issuance of reports of examinations 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.

Informal Enforcement Actions

When a thrift's overall condition is sound but it is necessary to obtain written commitments from its board of directors or management to ensure that identified problems and weaknesses will be corrected, OTS may use informal enforcement actions. OTS commonly uses informal enforcement actions for problems in well- or adequately-capitalized thrifts and for thrifts with a composite rating of 1, 2, or 3.

Informal actions notify a thrift's board and management that OTS has identified problems which warrant attention. A record of informal action is beneficial in case formal action is necessary later.

The effectiveness of informal action depends in part on the willingness and ability of a thrift to correct deficiencies that OTS notes. If a thrift violates or refuses to comply with an informal action, OTS cannot enforce compliance in federal court or assess civil money penalties for noncompliance. However, OTS may initiate more severe enforcement actions against a noncompliant thrift.

Informal enforcement actions include supervisory directives, memoranda of understanding, and board resolutions.

Formal Enforcement Actions

Formal enforcement actions are enforceable under the Federal Deposit Insurance Act. They are appropriate when a thrift has significant problems, especially when there is a threat of harm to the thrift, depositors, or the public. OTS uses formal enforcement actions when informal actions are considered inadequate, ineffective, or otherwise unlikely to secure correction of safety and soundness or compliance problems.

OTS can assess civil money penalties against thrifts and individuals for noncompliance with a formal agreement or final orders. OTS can also request a federal court to require a thrift to comply with an order. Unlike informal actions, formal enforcement actions are public.

Formal enforcement actions include cease and desist orders, civil money penalties, and prompt corrective action directives.

OTS Enforcement Guidelines

Considerations for determining whether to use informal action or formal action include the following:

- the extent of actual or potential damage, harm, or loss to the thrift because of the action or inaction;
- whether the thrift has repeated the illegal action or unsafe or unsound practice;
- the likelihood that the conduct will occur again;
- the thrift's record for taking corrective action in the past;
- the capability, cooperation, integrity, and commitment of the thrift's management, board of directors, and owners 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;
- whether the thrift's condition is improving or deteriorating; and
- the presence of unique circumstances.

OTS Assessments Paid by Charter

OTS funds its operations in part through semi-annual assessments on thrifts. OTS determines the assessment by adding together three components reflecting the thrift's size, condition, and complexity. OTS computes the size component by multiplying the thrift's total assets, as reported on the thrift financial report (TFR), by the applicable assessment rate. The condition component is a percentage of the size component and is imposed on thrifts that have a 3, 4, or 5 CAMELS composite rating. OTS imposes a complexity component if (1) a thrift administers more than $1 billion in trust assets, (2) the outstanding balance of assets fully or partially covered by recourse obligations or direct credit substitutes exceeds $1 billion, or (3) the thrift services over $1 billion of loans for others. OTS calculates the complexity component by multiplying set rates by the amounts by which the thrift exceeds each threshold. Table 5 shows the assessments that Charter paid to OTS from 2005 through 2009.

Table 5: Assessments Paid by Charter to OTS, 2005–2009

Billing Period	Exam Rating	Amount Paid
1/1/2005–6/30/2005	2	$ 106,308
7/1/2005–12/31/2005	2	114,142
1/1/2006–6/30/2006	2	127,213
7/1/2006–12/31/2006	2	133,884
1/1/2007–6/30/2007	2	144,534
7/1/2007–12/31/2007	2	149,987
1/1/2008–6/30/2008	2	159,315
7/1/2008–12/31/2008	2	171,703
1/1/2009–6/30/2009	3	248,378
7/1/2009–12/31/2009	3	243,601
Total		**$1,599,065**

Source: OTS.

Appendix 3
Glossary

Adversely classified asset	An asset rated as substandard, doubtful, or loss. Substandard assets are inadequately protected by the current worth and the paying capacity of the obligor or of the collateral pledged, if any. A doubtful asset has all the weaknesses of a substandard asset with the added characteristic that the weaknesses make collection or liquidation in full questionable and improbable. A loss asset is considered uncollectible and of such little value that continuation as a bankable asset is not warranted.
Allowance for loan and lease losses	An estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid.
Board resolution	A document designed to address one or more specific concerns identified by the Office of Thrift Supervision and adopted by a thrift's board of directors.
Brokered deposit	Any deposit that is obtained, directly or indirectly, from a deposit broker. The bank or thrift solicits deposits by offering rates of interest that are significantly higher than the rates offered by other insured depository institutions in its normal market area. Use of brokered deposits is limited to well-capitalized insured depository institutions and, with a waiver from the Federal Deposit Insurance Corporation, to adequately capitalized institutions. Undercapitalized institutions are not permitted to accept brokered deposits. (See 12 U.S.C. § 1831(f) and 12 C.F.R. 337.6.)
CAMELS	An acronym for performance rating components for financial institutions: <u>c</u>apital adequacy, <u>a</u>sset quality, <u>m</u>anagement, <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 best rating and 5 being the worst.
Capital restoration plan	A plan submitted to the appropriate federal banking agency by an undercapitalized insured depository institution. A capital restoration plan specifies the steps the insured depository institution is to take to become adequately capitalized, the levels of capital to be attained during each year in which the plan is in effect, how the institution is to comply with the restrictions or

	requirements then in effect, the types and levels of activities in which the institution is to engage, and any other information that the federal banking agency may require.
Cease and desist order	A type of formal enforcement action. A cease and desist order issued by the Office of Thrift Supervision normally requires the thrift to correct a violation of a law or regulation or an unsafe or unsound practice. The Office of Thrift Supervision may issue a cease and desist order in response to violations of federal banking, securities, or other laws by thrifts or individuals or if it believes that an unsafe and unsound practice or violation is about to occur.
Commercial real estate loan	A loan for real property where the primary or significant source of repayment is from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property. Commercial real estate loans include construction and real estate development loans, land development loans, and commercial property loans (e.g., for office buildings and shopping centers).
Compliance	The part of a financial institution examination that includes an assessment of how well the institution manages compliance with consumer protection and public interest laws and regulations, including the Bank Secrecy Act.
Concentration	As defined by the Office of Thrift Supervision, a group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of a thrift's core capital plus allowance for loan and lease losses. Concentrations include direct, indirect, and contingent obligations or large purchases of loans from a single counterparty.
Concentration risk	Risk in a loan portfolio that arises when a disproportionate number of an institution's loans are concentrated in one or a small number of financial sectors, geographical areas, or borrowers.
Construction and land development loans	Loans, secured by real estate, made to finance (a) land development (i.e., the process of improving land – laying sewers, water pipes, etc.) prior to erecting new

	structures or (b) the on-site construction of industrial, commercial, residential, or farm buildings.
Direct credit substitute	An institution's guaranty, purchase, or assumption of a recourse exposure from another organization. For example, a purchased subordinated security is a direct credit substitute.
Division of Resolutions and Receiverships	A division within the Federal Deposit Insurance Corporation that is charged with resolving failing and failed financial institutions, including ensuring that depositors have prompt access to their insured funds.
Federal Home Loan Bank System	A system of 12 regional cooperative banks created by Congress from which member institutions borrow funds to finance housing, economic development, infrastructure, and jobs. The system provides liquidity to member institutions that hold mortgages in their portfolios and facilitates the financing of mortgages by making low-cost loans, called advances, to members. Advances with a wide variety of terms to maturity, from overnight to long-term, are available to members and are collateralized. Advances are designed to prevent any possible loss to Federal Home Loan Banks, which also have a super lien (a lien senior or superior to all current and future liens on a property or asset) when institutions fail. To protect their position, Federal Home Loan Banks have a claim on any of the additional eligible collateral in a failed institution. In addition, the Federal Deposit Insurance Corporation has a regulation that reaffirms the priority of Federal Home Loan Banks, which can demand prepayment of advances when institutions fail.
Formal agreement	A type of formal enforcement action authorized by statute. Formal agreements are generally more severe than informal actions and are disclosed to the public. Formal actions are also enforceable through the assessment of civil money penalties.
Full-scope examination	Examination activities performed during the supervisory cycle that (1) are sufficient in scope to assign or confirm an institution's CAMELS composite and component ratings, (2) satisfy core assessment requirements, (3) result in conclusions about an institution's risk profile,

	(4) include onsite supervisory activities, and (5) generally conclude with the issuance of a report of examination.
Generally accepted accounting principles	A widely accepted set of rules, standards and procedures for reporting financial information established by the Financial Accounting Standards Board.
Impairment	Decline in fair value of a loan below the amortized cost basis.
Information technology examination	An examination that includes review and evaluation of the overall management of information systems used by a thrift and of the effectiveness of the internal audit and security functions for those systems.
Loan production offices	Banking offices that take loan applications and arrange financing for corporations and small businesses but that do not accept deposits. Loan applications taken by loan production offices are subject to approval by the lending institution.
Matter requiring board attention	A practice noted during an Office of Thrift Supervision examination of a thrift that deviates from sound governance, internal control, and risk management principles. The matter, if not addressed, may adversely affect the thrift's earnings or capital, risk profile, or reputation or may result in substantive noncompliance with laws or regulations, internal policies or processes, supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by the institution. Although matters requiring board attention are not formal enforcement actions, the Office of Thrift Supervision requires that thrifts address them. A thrift's failure to do so may result in a formal enforcement action.
Mortgage banking	The term refers to the origination, sale and servicing of mortgages. A mortgage banker takes an application from the borrower and issues a loan to the borrower. The mortgage banker then sells the loan to an investor and may retain or sell the servicing of the loan that includes collecting monthly payments, forwarding the proceeds to the investors who purchased the loan, and acting as the investor's representative for other issues and problems with the loan.

Mortgage servicing rights	A contractual agreement where the right or rights to service an existing mortgage are sold by the original lender to another party who specializes in the various functions of servicing mortgages.
Non-homogeneous assets	Assets that are disparate and unrelated to each other such as real estate owned and multi-family real estate, nonresidential real estate, commercial business loans, and construction loans.
Prompt corrective action	A framework of supervisory actions for insured institutions that are not adequately capitalized. It was intended to ensure that action is taken when an institution becomes financially troubled in order to prevent a failure or minimize resulting losses. These actions become increasingly severe as an institution falls into lower capital categories. The capital categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. (See 12 U.S.C. § 1831o.) The prompt corrective action minimum requirements are as follows:

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

[a] To be well-capitalized, a thrift also cannot be subject to a higher capital requirement imposed by the Office of Thrift Supervision.

Recourse	With respect to financial assets such as loans, the legal ability of the purchaser of an asset to make a claim against the seller of the asset if the debtor fails to pay. For example, a loan sold with a recourse provision would allow the loan's purchaser to make a claim against the loan's seller in the event of debtor default.

Risk-based capital	The sum of Tier1 plus Tier 2 capital.
Safety and soundness	The part of an examination that includes a review and evaluation of each CAMELS component (see explanation of CAMELS, above).
Special mention asset	An asset that has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.
Subordinated debt	Debt that is either unsecured or has a lower priority than that of another debt claim on the same asset or property. Subordinated debt is also called junior debt.
Substandard asset	An asset that is inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Assets classified as substandard must have a well-defined weakness, or weaknesses that jeopardize the liquidation of the debt. A substandard asset presents the distinct possibility that the institution holding it will sustain some loss if the asset’s deficiencies are not corrected.
Supervisory directive	An informal enforcement action by the Office of Thrift Supervision that directs a thrift to cease an activity or take an affirmative action to remedy or prevent an unsafe or unsound practice.
Tangible equity	Total assets minus intangible assets minus total liabilities.
Tier 1 capital	Common shareholder’s equity (common stock, surplus, and retained earnings), noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.
Tier 2 capital	Subordinated debt, intermediate-term preferred stock, cumulative and long-term preferred stock, and a portion of the allowance for loan and lease losses.

Thrift financial report	A financial report that thrifts are required to file quarterly with the Office of Thrift Supervision. The report includes detailed information about the institution's operations and financial condition and must be prepared in accordance with generally accepted accounting principles. The thrift financial report is similar to the call report required of commercial banks.
Transaction Account Guarantee Program	A component of the Federal Deposit Insurance Corporation’s Temporary Liquidity Guarantee Program. The Temporary Liquidity Guarantee Program was established in October 2008 as part of a coordinated effort by the Federal Deposit Insurance Corporation, the Department of the Treasury, and the Federal Reserve Board to address unprecedented disruptions in credit markets and the resultant inability of financial institutions to fund themselves and make loans to creditworthy borrowers. The Temporary Liquidity Guarantee Program has two distinct components: (1) the Debt Guarantee Program and (2) the Transaction Account Guarantee Program. The Federal Deposit Insurance Corporation guarantees certain senior unsecured debt issued by participating entities under the Debt Guarantee Program and all funds held in qualifying noninterest-bearing transaction accounts at participating insured depositary institutions under the Transaction Account Guarantee Program. Originally scheduled to expire on December 31, 2009, the Transaction Account Guarantee Program was extended in August 2009 until June 30, 2010. Participating insured depositary institutions pay an assessment fee for the additional guarantee.
Wholesale funding	Funding obtained by financial institutions through such sources as federal funds, public funds, FHLB advances, the Federal Reserve Board’s primary credit program, foreign deposits, and brokered deposits.

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Department of the Treasury
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Thomas A. Barnes
Deputy Director, Examinations, Supervision, and Consumer Protection

May 6, 2011

MEMORANDUM FOR:	Mayer Hoffman McCann P.C. Contractor to Office of Inspector General U.S. Department of the Treasury
FROM:	Thomas A. Barnes /s/ Deputy Director
SUBJECT:	Draft Material Loss Review of Charter Bank Santa Fe, New Mexico

Thank you for the opportunity to comment on your draft memorandum entitled "Charter Bank Material Loss Review." Our review was limited to the draft "Safety and Soundness Performance Audit" performed by Mayer Hoffman McCann P.C.

The memorandum summarizes the primary causes of the Bank's failure, which are consistent with the information contained in the OTS Reports of Examination and documents in support of the grounds for receivership. Specifically, the memorandum cites high concentrations in construction and land lending, and notes that management and the board had poorly positioned the Bank by concentrating assets in higher risk acquisition, development and construction loans. As a consequence, the Bank suffered large operating losses due to high loan loss provisions and declining net interest margins with a corresponding erosion of insufficient capital levels. The memorandum identified no unusual circumstances surrounding the Bank's failure.
With regard to the recommendations contained in the memorandum, we offer the following:

1) *Ensure that action is taken on the recommendations made in the OTS failed thrift institution review of Charter.*

   OTS completed its Internal Failed Bank Review of Charter Bank on August 4, 2010. OTS, as recommended in previous Failed Bank Reviews, issued additional examination guidance to staff to impose higher capital requirements and/or require prudent limits for higher-risk lending concentrations. Since May 2008, OTS has issued a variety of examiner guidance bulletins addressing lessons learned from previous internal failed bank reviews. These bulletins included examiner guidance for concentration risk

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May 6, 2011

management and establishment of concentration risk limits as well as authority to impose higher capital requirements.

2) *Reemphasize to examiners the importance of following sampling guidance on its review of non-homogeneous loans, including situations where minimum sample sizes should be increased for risks inherent in the loan portfolio or the results of its loan reviews include significant downgrades to classified asset categories.*

   OTS agrees with the recommendation.

3) *Work with its regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high risk concentrations.*

   OTS issued CEO Letter 311 in July, 2009 addressing increased regulatory scrutiny for concentration risk management, including requiring board established limits and controls. The letter also communicated OTS will pursue appropriate corrective action or enforcement action when an institution does not maintain appropriate concentration limits or takes excessive risks. OTS supports all opportunities to promote safe and sound business practices on an inter-agency basis. We shall continue to work with the other federal agencies to the fullest extent possible until the implementation of the Dodd-Frank Act transfers OTS responsibilities to the other respective federal banking regulatory agencies.

Thank you again for the opportunity to review and respond to the draft review of Charter Bank. OTS appreciates the professionalism and courtesies provided by the staffs of Mayer Hoffman McCann and the Office of Inspector General.

Section II

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