Audit Report

OIG-11-082

SAFETY AND SOUNDNESS: Material Loss Review of Bradford Bank

July 13, 2011

Office of Inspector General

Department of the Treasury

Contents

Abbreviations

ALLL	allowance for loan and lease losses
ERC	Enforcement Review Committee
FDIC	Federal Deposit Insurance Corporation
IPO	initial public offering
MHC	Bradford Bank, Mutual Holding Company
OIG	Treasury Office of Inspector General
OTS	Office of Thrift Supervision
PCA	prompt corrective action
ROE	report of examination
TFR	thrift financial report

OIG

Audit Report

The Department of the Treasury
Office of Inspector General

July 13, 2011

John E. Bowman, Acting Director
Office of Thrift Supervision

This report presents the results of our review of the failure of Bradford Bank (Bradford) of Baltimore, Maryland, and the Office of Thrift Supervision's (OTS) supervision of the institution. OTS closed Bradford and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on August 28, 2009. This review is mandated by section 38(k) of the Federal Deposit Insurance Act because of the magnitude of Bradford's estimated loss to the Deposit Insurance Fund.[1,2] As of September 20, 2010, FDIC estimated that the loss would be $96.3 million.

Our objectives were to determine the causes of Bradford's failure; assess OTS's supervision of Bradford, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish these objectives, we reviewed the supervisory files and interviewed officials at OTS and FDIC. We conducted our fieldwork from November 2009 through February 2010. Appendix 1 contains a more detailed description of our objectives, scope, and methodology. Appendix 2 contains background information on Bradford's history, including fee assessments paid to OTS and examination hours by OTS.

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[1] At the time of Bradford's failure, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. Effective July 21, 2010, section 38(k) defines a loss as material if it exceeds $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar years 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met).

[2] Certain terms that are underlined when first used in this report, are defined in, *Safety and Soundness: Material Loss Review Glossary*, OIG-11-065 (April 11, 2011). That document is available on the Treasury Office of Inspector General's (OIG) website at http://www.treasury.gov/about/organizational-structure/ig/Pages/by-date-2011.aspx.

In brief, Bradford failed because of (1) significant loan delinquencies and losses incurred on its higher-risk commercial real estate loans, (2) its acquisition and merger activities, (3) a failed initial public offering (IPO),[3] and (4) weak oversight by the board of directors and management. OTS did not (1) limit or restrict the thrift's concentration in high-risk commercial real estate loans, nor (2) take timely enforcement action. OTS used its authority under PCA as Bradford's capital levels fell, but the PCA taken did not prevent the failure.

In light of the upcoming transfer of OTS functions to other federal banking agencies on July 21, 2011, we are not making any recommendations as a result of our material loss review of the Bradford failure.[4] In a written response, OTS acknowledged and concurred with the conclusions in our report. OTS's response is included as appendix 3.

Causes of Bradford's Failure

Bradford failed because of significant loan delinquencies and losses incurred on its higher-risk commercial real estate loans. Other contributing factors to the failure were Bradford's acquisition of a thrift, its merger with two other thrifts, and a failed IPO to raise capital. The growth of Bradford's commercial loan real estate portfolio, its acquisition and mergers, and its IPO attempt resulted from an aggressive growth strategy that the thrift implemented in February 2006. Furthermore, Bradford's board failed to adequately ensure that the thrift operated in a safe and sound manner.

Bradford Developed High Concentrations in Land, Construction, and Nonresidential Mortgage Loans

In January 2006, Bradford embarked on a poorly planned aggressive growth strategy to reach $1 billion in assets over a 3-year period primarily by increasing higher-risk commercial lending, especially land loans. As of December 31, 2007, land,

[3] Initial public offering is the first sale of stock by a company to the public.
[4] The transfer of OTS functions is pursuant to P.L. 111-203.

construction, and nonresidential mortgage loans represented Bradford's largest groups of nonperforming loans. From December 2007 to December 2008, the total value of the thrift's nonperforming land, construction, and nonresidential mortgage loans increased from $7.9 million to $30.1 million. Although Bradford slowed its land, construction, and nonresidential lending in the beginning of 2008, the losses sustained on already existing loans caused capital to decline. OTS's 2006 report of examination (ROE) for Bradford noted that the thrift's capital, while meeting regulatory requirements for well-capitalized status, was strained by the thrift's growth and was of particular concern because of Bradford's risk profile.

Bradford Also Pursued Growth Through Acquisition and Merger

In January 2007, Bradford Bancorp, Inc., the thrift's holding company, acquired Valley Bank, a thrift with $49.4 million in assets.[5] To maintain Bradford's well-capitalized status, the holding company obtained a $3 million dollar loan from Banker's Bank, which it downstreamed to Bradford.[6] In June 2007, Bradford merged with Senator Bank and Golden Prague Federal Savings and Loan Association (Golden Prague), resulting in combined total assets of approximately $50 million. Bradford's pro forma balance sheet that incorporated the acquisition of Valley Bank, the Senator Bank and Golden Prague mergers, and the additional capital from Bradford Bancorp, Inc., reported Bradford as well-capitalized, with a total risk-based capital ratio for the consolidated entity at 10.1 percent.

The Securities and Exchange Commission later determined that Bradford would have to change the accounting method it used

[5] Bradford was organized under a two-tier mutual holding company structure. Bradford Bank, Mutual Holding Company (Bradford Bank MHC), was the top-tier entity, and Bradford Bancorp, Inc. (later renamed Bradford Mid-Tier Company), was the second-tier company and owner of Bradford.

[6] Banker's Bank became Silverton Bank, N.A., which the Office of the Comptroller of the Currency closed and appointed the FDIC as receiver on May 1, 2009. We issued an MLR on Silverton – *Safety and Soundness: Material Loss Review of Silverton Bank, N.A.*, OIG-10-033 (Jan. 22, 2010).

for the mergers of Senator Bank and Golden Prague from the purchase method to the pooling method.[7] Pooling required Bradford to recognize $2 million in merger-related expenses immediately, instead of capitalizing them. Although Bradford stayed well-capitalized throughout the acquisition and mergers, these transactions eliminated the capital cushion the thrift had above the well-capitalized minimum total risk-based capital ratio. In addition, Valley Bank, Senator Bank, and Golden Prague each brought additional higher-risk loans to Bradford's already high concentration of loans.

Failed Initial Public Offering

Bradford planned on selling stock to the public through its holding company. The thrift estimated that it would raise $70 million in capital from the offering and planned to merge with Patapsco Bank, which had approximately $230 million in assets, after the IPO. Because of a weakening demand for bank stocks, Bradford was able to raise only $13 million in commitments from investors to purchase stock. In January 2008, Bradford canceled the IPO and returned the $13 million to the investors. The failed IPO caused Bradford to immediately recognize $2 million in related expenses. Additionally, Bradford paid $2 million to Patapsco as an acquisition cancellation fee. Bradford's failed IPO left the thrift with unsafe concentrations of credit, and the losses sustained in its loan portfolios depleted Bradford's capital and contributed to its failure.

Bradford's Board of Directors and Management Provided Weak Oversight

Bradford's board and management were responsible for operating the thrift in a safe and sound manner but failed to do so. The board ignored OTS's warnings in 2006 about growth

[7] The purchase method is a method of acquisition accounting where the consolidated balance sheet of the buying firm records the acquired assets revalued at the market price less liabilities assumed at cost, and the difference between the purchase price and the revalued net assets as goodwill. Goodwill is then amortized over the permitted period or treated as a tax deductible expense. The pooling method is an accounting method where the assets and liabilities of acquired or merged firm(s) are taken item by item and combined with the balance sheet of the surviving firm.

and the thrift's capital position and did not take adequate action in response to an internal analysis about the weakened local housing market. The board also failed to ensure that Bradford had adequate capital to support growth. Despite these warnings, the board continued to approve high-risk commercial real estate loans, further increasing the thrift's risk profile.

Regulation O Violation

While not a contributing factor to the failure, we found that in May 2007, the board approved a $10 million commercial loan to a business principally owned by its chairman. As a result of this loan, OTS cited Bradford for a Regulation O violation in the 2008 ROE for the thrift.[8] OTS informed Bradford that the loan violated Regulation O because it exceeded the $100,000 threshold for loans to executive officers. Bradford ultimately sold the loan to another institution.

OTS's Supervision of Bradford

OTS conducted timely full-scope examinations of Bradford and provided oversight through quarterly off-site monitoring. However, OTS did not ensure that appropriate limits were established on the thrift's asset concentration. Also, OTS's enforcement actions against Bradford and its holding company were not timely.

Table 1 summarizes the results of OTS's safety and soundness examinations and limited examinations of Bradford from 2006 until its closure in August 2009.[9]

[8] The Federal Reserve Board's Regulation O, 12 C.F.R. part 215 (implemented by OTS through 12 C.F.R. 563.43) sets various restrictions on extensions of credit to executive officers, directors, and principal shareholders of the association and its affiliates and to the related interests of these executive officers, directors, and principal shareholders.
[9] OTS conducted its examinations and performed offsite monitoring of Bradford in accordance with the timeframes prescribed in the OTS Examination Handbook.

Table 1: Summary of OTS's Examinations of Bradford (December 2006 - June 2009)

Date started/ completed/ type of examination	Assets (millions)	Examination Results			
		CAMELS rating	No. of MRBAs	No. of corrective actions	Enforcement actions
12/11/2006 02/07/2007 (full-scope examination)	$451	2/222223	4	7	None
02/19/2008 06/01/2008 (full-scope examination)	$563	3/333334	12	16	Notice of Troubled Condition issued 12/30/2008 C&D orders issued 2/26/2009
02/18/2009 03/04/2009 (limited examination)	$504	4/443334	0	0	None
04/20/2009 07/01/2009 (full-scope examination)	$462	5/555545	10	21	None
06/05/2009 06/05/2009 (limited examination)	$483	5/553334	0	0	PCA directive executed 7/24/2009

Source: OTS report of examinations.

OTS Did Not Effectively Limit Bradford's Concentration Levels

According to the June 2005 OTS Handbook, examiners should include in the ROE, concentrations that present a supervisory concern, for example, those concentrations that exceed 25 percent of core capital plus the allowance for loan and lease losses (ALLL). When loans have an especially high risk of loss, examiners should report even lower levels of concentrations, such as 10 percent of capital plus ALLL. In addition, if the examiner's review indicates significant asset quality concerns, the examiner may need to expand the review to additional portfolios.

In the 2006 ROE, OTS stated that Bradford had several higher-risk asset categories that represented investments in excess of 25 percent of the bank's core capital plus the allowance, and management needed to enhance its internal review process because of the concentrations. The ROE also stated that Bradford continued to focus on expanding its higher-risk commercial portfolio, which increased by $25 million during the review period, with additional growth planned. As of September 30, 2006, higher-risk commercial loans totaled 383 percent of core capital plus the allowance for loan and lease losses. Although there were four MRBAs issued in 2006, none addressed Bradford's concentration levels. OTS examiners for Bradford told us that it was difficult to limit concentrations due to a lack of guidance.

Notwithstanding the statements by the examiners, we believe that OTS should have taken stronger action to address the high concentrations identified by its 2006 examination. By 2007, Bradford's problem loans increased because of the weakening real estate market and the thrift's exposure to these higher-risk commercial loans. In the 2008 ROE, OTS identified concentrations in land loans, construction loans, and nonresidential mortgages as well as significant weaknesses associated with these loans.

In July 2009, OTS issued additional guidance to thrifts on asset and liability concentrations and related risk management practices to address the need for more guidance on concentration limits.[10] The guidance re-emphasized important risk management practices and encouraged institutions to revisit existing concentration policies given the current economic environment. The guidance informed thrifts that OTS examiners will closely review and scrutinize higher risk concentrations and

[10] OTS issued this guidance in a memorandum "Risk Management: Asset and Liability Concentrations" on July 9, 2009.

pursue appropriate corrective action or enforcement action when an institution does not maintain appropriate concentration limits or takes excessive risks. The guidance stated that OTS will monitor all concentrations and will closely review institutions that establish high internal limits, particularly if they exceed 100 percent of core capital plus the ALLL. While we believe the guidance is better than what had been available to thrifts previously, it is too soon to tell whether the guidance will be effective at controlling risky concentrations going forward. This is an area we believe requires continued supervisory attention.

OTS Did Not Take Timely Enforcement Action

OTS took enforcement actions against Bradford and its holding company, Bradford Bank Mutual Holding Company (Bradford Bank MHC), but the actions were not timely. The OTS Southeast Region Supervisory Action Committee[11] recommended issuing a cease and desist order to Bradford and Bradford Bank MHC on June 26, 2008. However, the cease and desist order was not issued until February 26, 2009. OTS officials explained that the 8-month delay was a result of the draft cease and desist orders being exchanged a number of times for review between the OTS Southeast Region's Counsel and Bradford's lawyers.

OTS recognized the need for formal guidance on issuing and tracking enforcement actions by releasing the New Directions Bulletin 09 11a on August 7, 2009. The bulletin established national guidelines for issuing enforcement actions recommended by Regional Enforcement Review Committees, which replaced the Regional Supervisory Action Committees.[12]

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[11] Established in each OTS region, the purpose of the Supervisory Action Committee is to ensure consistent, fair, timely and appropriate implementation and resolution of enforcement actions.
[12] The New Directions Bulletin, "Timeframe Objectives Conformed to Exam Ratings," states that regional staff should complete formal enforcement actions and provide them to the thrift within 30 calendar days of the ERC meeting, to take effect within 60 calendar days of the ERC meeting. In addition, the bulletin states that if the thrift does not execute the action within the prescribed timeframes, OTS should consider taking additional supervisory action.

OTS Used Prompt Corrective Action as Bradford's Capital Levels Declined

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

OTS took the following key actions related to Bradford. The PCA taken, however, did not prevent the failure of Bradford.

On May 26, 2009, OTS notified Bradford that it was significantly undercapitalized based on the thrift's March 31, 2009, thrift financial report (TFR) filed April 30, 2009.[13] OTS required that Bradford file a capital restoration plan with OTS by June 8, 2009. On June 4, 2009, Bradford submitted the capital restoration plan, calling for a capital infusion from an investor or acquisition by another institution. On July 7, 2009, OTS determined the plan to be unacceptable because it appeared unlikely that the thrift would find an investor or acquirer without government assistance.

On July 8, 2009, OTS notified Bradford that (1) it was critically undercapitalized according to PCA requirements, based on the June 12, 2009, amendments to the thrift's March 31, 2009, TFR; (2) its capital restoration plan was disapproved; and (3) OTS was requesting that Bradford's board consent to a PCA directive. On July 24, 2009, OTS executed a PCA directive between OTS and Bradford that included the consent of the thrift's board to the appointment of a receiver.

[13] As of the December 31, 2008 TFR, Bradford's total risk-based capital was reported as adequately capitalized.

OTS's Failed Bank Review

In March 2010, OTS completed an internal failed bank review of Bradford's failure. The OTS review concluded that Bradford's failure was caused by high levels of problem assets that steadily eroded capital. The report stated that the primary area in which OTS could have improved its supervision of Bradford was identification and control of the thrift's high-risk asset concentrations. The report on the review recommended that examination and supervisory staff consider higher capital requirements and absolute limits on higher-risk lending concentrations. The report also recommended that OTS follow national guidelines for enforcement actions and ensure appropriate and timely implementation of such actions. Our material loss review affirms the findings and recommendations of OTS's failed bank review.

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We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-6512 or Susan Roy, Audit Manager, at (202) 927-5746. Major contributors to this report are listed in appendix 4.

Michael J. Maloney /s/
Audit Director

We conducted a material loss review of Bradford Bank of Baltimore, Maryland (Bradford), in response to our mandate under section 38(k) of the Federal Deposit Insurance Act.[14] This section provides that if the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the inspector general for the appropriate federal banking agency is to prepare a report to the agency that

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

At the time of Bradford's failure, a loss was defined as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. We initiated a material loss review of Bradford based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of September 20, 2010, FDIC estimated that the loss to the Deposit Insurance Fund from Bradford's failure would be $96.3 million.

To accomplish our review, we conducted fieldwork at OTS's headquarters in Washington, D.C.; OTS's Southeast Region office in Atlanta, Georgia; and Bradford's former headquarters office in Baltimore, Maryland. We conducted our fieldwork from November 2009 through February 2010.

To assess the adequacy of OTS's supervision of Bradford, we determined (1) when OTS first identified Bradford'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:

[14] 12 U.S.C. § 1831o(k).

We determined that the time period relating to OTS's supervision of Bradford covered by our audit would be from January 2006 through August 28, 2009, the date of Bradford's failure. This period included three full-scope safety and soundness examinations and two limited-scope examinations.

- We reviewed OTS's supervisory files and records for Bradford from January 2006 through August 2009. We analyzed examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology 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 Bradford with OTS officials and examiners to obtain their perspective on the thrift's condition and the scope of the examinations.

- We interviewed investigators under contract to the FDIC Division of Resolutions and Receiverships for federal deposit insurance purposes.

- We reviewed Bradford documents taken 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.[15]

- We reviewed OTS's March 10, 2010, internal failed bank report for Bradford.

[15] 12 U.S.C. § 1811 et seq.

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.

Bradford Bank History

Bradford Bank (Bradford) opened in 1903 and was headquartered in Baltimore, Maryland. Until its closure on August 28, 2009, it operated nine branches in the greater Baltimore area. On July 15, 2005, Bradford Bank, Mutual Holding Company (MHC), was formed as Bradford's top-tier MHC, and Bradford Mid-Tier Company was formed as the second-tier holding company.

OTS Assessments Paid by Bradford

OTS funds its operations in part through semiannual assessments on savings associations. OTS determines each institution's assessment by adding together three components reflecting the size, condition, and complexity of an institution. OTS computes the size component by multiplying an institution's total assets as reported on the thrift financial report by the applicable assessment rate. The condition component is a percentage of the size component and is imposed on institutions 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 times the amounts by which an association exceeds each particular threshold. Table 2 shows OTS's paid assessments for Bradford for 2006 through 2009.

Table 2: OTS's Assessments Paid by Bradford 2006–2009

Billing Period	Examination Rating	Amount Paid
01/01/2006–06/30/2006	2	$48,825
07/01/2006–12/31/2006	2	$50,697
01/01/2007–06/30/2007	2	$59,728
07/01/2007–12/31/2007	2	$66,631
01/01/2008–06/30/2008	2	$68,974
07/01/2008–12/31/2008	3	$99,575
01/01/2009–06/30/2009	3	$96,969
07/01/2009–12/31/2009	5	$117,342

Source: OTS.

Number of OTS Staff Hours Spent Examining Bradford

Table 3 shows the number of OTS staff hours spent examining Bradford from 2006 to 2009.

Table 3: OTS Hours

Start Date of Examination	Number of OTS Examination Hours
12/11/2006	948
02/19/2008	1,092
04/20/2009	2,136

Source: OTS.

Office of Thrift Supervision
Department of the Treasury

Thomas A. Barnes
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July 12, 2011

MEMORANDUM FOR: Michael Maloney
Audit Director
Office of Inspector General

FROM: Thomas A. Barnes /s/
Deputy Director

SUBJECT: Draft Audit Report on the Material Loss Review (MLR) of Bradford Bank

Thank you for the opportunity to comment on the draft Material Loss Review Report (Report) for Bradford Bank prepared by the Department of the Treasury Office of Inspector General (OIG). The stated objectives of the Report were to determine the causes of Bradford's failure; assess OTS's supervision of Bradford, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such a loss in the future. The Report concluded that Bradford failed because of significant loan delinquencies and losses incurred on its higher-risk commercial real estate loans; its acquisition and merger activities; a failed initial public offering; and, weak oversight by the board of directors and management. The Report also concluded that OTS did not limit or restrict the thrift's concentration in high-risk commercial real estate loans, nor take timely enforcement action. The Report found that OTS used its authority under PCA as Bradford's capital levels fell, but the PCA taken did not prevent the failure. The Report contained no recommendations in light of the upcoming transfer of OTS functions to other federal banking agencies on July 21, 2011.

We acknowledge and concur with the conclusions in the Report.

Thank you again for the opportunity to review and respond to the draft Report. OTS appreciates the professionalism and courtesies provided by your staff on behalf of the Office of Inspector General.

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Susan I. Roy, Audit Manager
Ronda R. Richardson, Auditor-in-Charge
Horace A. Bryan, Auditor
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Department of the Treasury

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

Office of Thrift Supervision

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Comptroller General of the United States