



# Audit Report



OIG-11-084

SAFETY AND SOUNDNESS: Material Loss Review of Partners Bank

July 14, 2011

## Office of Inspector General

Department of the Treasury



# Contents

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**Memorandum for the Acting Director**

**Section I KPMG LLC's Report on the Material Loss Review of Partners Bank**

**Section II Report Distribution**

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DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

OFFICE OF  
INSPECTOR GENERAL

July 14, 2011

**MEMORANDUM FOR JOHN E. BOWMAN  
ACTING DIRECTOR**

**FROM:** Susan Barron /s/  
Director, Banking Audits

**SUBJECT:** Material Loss Review of Partners Bank

**INTRODUCTION**

The Office of Thrift Supervision (OTS) closed Partners Bank (Partners), Naples, Florida, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on October 23, 2009. As of May 26, 2011, FDIC estimated that Partners' loss to the Deposit Insurance Fund was \$34.6 million.

Under section 38(k) of the Federal Deposit Insurance Act, we are responsible for conducting a material loss review of the failure of Partners.<sup>1</sup> To help fulfill this responsibility, we contracted with KPMG LLP (KPMG), an independent certified public accounting firm. KPMG's report dated July 14, 2011, is provided as Section I.

**RESULTS OF MATERIAL LOSS REVIEW**

We concur with KPMG's reported conclusions regarding Partners' causes of failure and OTS's supervision of Partners:

- Partners failed primarily because of (1) loan concentrations, (2) aggressive underwriting and poor risk management, (3) failure to formulate and execute a viable business plan, (4) poor management and board oversight, and (5) inadequate capital levels. These factors, combined with the rapid decline in the economic environment, resulted in the deterioration of Partners' asset

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<sup>1</sup> At the time of Partners' 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 be raised temporarily to \$75 million under certain conditions).

quality, including a substantial volume of problem loans and significant loan losses. In turn, these loan losses significantly diminished earnings and eroded capital, and ultimately, resulted in the failure of Partners.

- Through its supervisory efforts, OTS identified key risks in Partners' management practices and operations and brought these risks to the attention of Partners' board of directors and management team through regular discussions and correspondence, on-site examinations, examination reports, and formal supervisory actions. OTS conducted three full-scope examinations beginning in 2006. However, OTS's supervision did not adequately address Partners' problems early enough to prevent and/or minimize losses to the Deposit Insurance Fund. OTS failed to enforce conditions of Partners' charter approval order; did not accurately rate Partners' asset quality, management, and earnings CAMELS<sup>2</sup> components; failed to enforce conditions of the branch application approval; and failed to issue an informal enforcement action when OTS classified Partners as a composite 3-rated institution.

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

We also concur with KPMG's recommendations in the report that:

- OTS (1) take action on OTS's internal failed bank review of Partners, (2) ensure supervisory staff enforce compliance with conditions of approved charters, (3) caution supervisory staff to exercise OTS's discretion to impose additional conditions when approving modifications to an existing approved business plan, particularly when management does not fully comply with the original business plan, (4) caution supervisory staff to consider whether additional capital should be required and in place prior to permitting an institution to proceed with a business plan that requires additional capital, and (5) remind supervisory staff to consider OTS guidance regarding informal enforcement action when a bank is 3-rated.

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<sup>2</sup> CAMELS is an acronym for performance rating components for financial institutions: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Numerical values range from 1 to 5, with 1 being the best rating and 5 being the worst.

In a written response, OTS acknowledged and concurred with KPMG's conclusions and recommendations in the report. OTS believes the policies, procedures and guidance it has put in place address the recommendations contained in the report. It should also be noted that effective July 21, 2011, the functions of OTS are to transfer to other federal banking agencies.

### **OBJECTIVES, SCOPE, AND METHODOLOGY**

Under section 38(k), we are responsible to prepare a report to OTS that (1) ascertains why Partners' 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 assist us in fulfilling this responsibility, we contracted with KPMG 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 the documentation of KPMG; met with partners and staff members; evaluated the 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.

Should you wish to discuss the report, you may contact me at (202) 927-5776.

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**Section I**

**KPMG LLC's Report on the  
Material Loss Review of Partners Bank**

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**U.S. Department of Treasury Office of Inspector General**

**Material Loss Review of Partners Bank**

**July 14, 2011**



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## Abbreviations

ALLL	allowance for loan and lease losses
C&D	cease and desist order
CEO	chief executive officer
CRE	commercial real estate
FDIC	Federal Deposit Insurance Corporation
MRBA	matter requiring board attention
OIG	Treasury 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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**July 14, 2011**

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### **Material Loss Review Report for Partners Bank, Naples, Florida**

This report presents the results of our work conducted to address the performance audit objectives relative to the Material Loss Review for Partners Bank (Partners), Naples, Florida. The objectives of this performance audit were to (1) determine the causes of Partners' failure and the resulting material loss to the Deposit Insurance Fund (DIF), (2) evaluate the Office of Thrift Supervision's (OTS) supervision of Partners, including OTS's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the Federal Deposit Insurance Act, and (3) make recommendations for preventing a material loss in the future.<sup>1</sup>

#### *Causes of Failure*

Partners' failure can be attributed to (1) loan concentrations, (2) aggressive underwriting and poor risk management, (3) failure to formulate and execute a viable business plan, (4) poor management and board oversight and (5) inadequate capital levels. These factors, combined with the rapid decline in the economic environment, resulted in the deterioration of the thrift's asset quality, including a substantial volume of problem loans, and significant loan losses. In turn, these loan losses significantly diminished earnings, negatively impacted capital, and ultimately resulted in the failure of Partners.

#### *Evaluation of Supervision*

Through its supervisory efforts, OTS identified key risks in Partners' management practices and operations and brought these risks to the attention of Partners' board of

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<sup>1</sup> In conducting this performance audit and preparing this report, KPMG relied primarily on information provided by OTS. Appendix I, Objective, Scope and Methodology, describes in greater detail the procedures used by KPMG.

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directors and management team through regular discussions and correspondence, on-site examinations, examination reports, and formal supervisory actions. OTS conducted three full-scope examinations beginning in 2006. However, we noted that OTS's supervision did not adequately address Partners' problems early enough to prevent and/or minimize losses to the DIF. OTS failed to enforce conditions of Partners' charter approval order; did not accurately rate Partners' asset quality, management, and earnings CAMELS components; failed to enforce conditions of the branch application approval; and failed to issue an informal enforcement action when OTS classified Partners as a composite 3-rated institution.

#### *Prompt Corrective Action*

OTS followed its PCA implementation guidance with respect to Partners, except for one instance where OTS did not provide a timely notice of intent to issue a PCA directive stating that the bank had failed to submit a capital restoration plan. Partners' capital levels deteriorated rapidly as Partners was considered *Well Capitalized* for PCA purposes as of December 31, 2008, *Undercapitalized* for PCA purposes as of March 31, 2009, and *Critically Undercapitalized* for PCA purposes as of June 30, 2009; however, by the time OTS issued a PCA capital directive, Partners was already considered *Critically Undercapitalized* and was at risk of failure.

#### *OTS Internal Failed Bank Review*

OTS conducted an internal failed bank review of Partners' failure and found that Partners' failure primarily resulted from high levels of problem assets that steadily eroded capital. Partners' deteriorating asset quality and continuing significant operating deficiencies eliminated any prospective acquirers or merger with Partners in order to recapitalize Partners Financial Corporation (Partners' holding company) and Partners. The OTS review noted that concentrations of risk were also a contributor to Partners' failure. OTS's review concluded that it should have (1) been more aggressive in its supervisory approach when a de novo institution deviates from its approved business plan and (2) considered higher capital requirements as well as absolute limitations of higher-risk-lending concentrations.

#### *Recommendations to Prevent Future Losses*

We recommend that OTS (1) take action on its internal failed bank review of Partners; (2) ensure supervisory staff enforce compliance with conditions of charter approval; (3) caution supervisory staff to exercise discretion to impose additional conditions when approving modifications to an existing approved business plan, particularly when management does not fully comply with the original business plan; (4) caution supervisory staff to consider whether additional capital should be required and in place prior to permitting an institution to proceed with a business plan that requires additional capital; and (5) remind supervisory staff to comply with OTS guidance regarding informal



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enforcement action when a bank is a composite 3-rated. In a written response, OTS acknowledged and concurred with our conclusions and recommendations in the report. OTS believes the policies, procedures and guidance it has put in place address the recommendations contained in the report.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require that we plan and perform the performance 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.

This performance audit did not constitute an audit of financial statements in accordance with *GAGAS*. We were not engaged to, and did not, render an opinion on the Treasury OIG or OTS's internal controls over financial reporting or over financial management systems (for purposes of OMB's Circular No. A-127, *Financial Management Systems*, July 23, 1993, as revised). We caution that projecting the results of our evaluation to future periods is subject to the risks that controls may become inadequate because of changes in conditions or because compliance with controls may deteriorate.

The information included in this report was obtained during our fieldwork, which occurred during the period from January 19, 2010 through August 23, 2010, and our results are as of July 14, 2011.

Very truly yours,

/s/

KPMG

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## Causes of Partners Bank's Failure

The primary causes of Partners' failure were (1) loan concentrations,<sup>2</sup> (2) aggressive underwriting and poor risk management, (3) failure to formulate and execute a viable business plan, (4) poor management and board oversight, and (5) inadequate capital levels. These factors, combined with the rapid decline in the economic environment, resulted in the deterioration of the Partners' asset quality, including a substantial volume of problem loans and significant loan losses. In turn, these loan losses significantly diminished earnings and eroded capital, and ultimately, resulted in the failure of Partners.

### Loan Concentrations by Year of Origination and in Construction and Land Loans

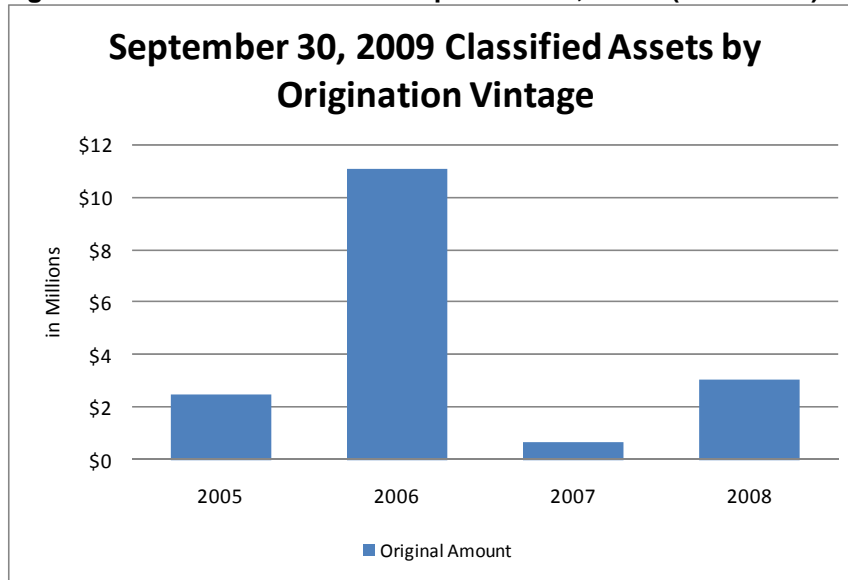
Partners opened in 2005 during a time period viewed in retrospect by OTS Southeast Region supervisory staff as the peak of the Naples real estate market. It was implicit in OTS's approvals of Partners' charter and business plan that Partners would begin originating its loan portfolio in 2005 and continue to originate loans throughout 2006. Due to the timing of Partners' opening, a majority of the loan portfolio was originated at the height of the Florida real estate market, leaving Partners more susceptible to loan defaults because of the subsequent decline in real estate market values. Having an entire loan portfolio that was more susceptible to default as a result of loan balances exceeding the underlying asset values when the Florida real estate values dropped precipitously was detrimental to Partners.

Partners had \$12.5 million of classified assets at September 30, 2009, one month before Partners was placed into receivership. As figure 1 shows, loans originated in 2006 were the largest group of those classified assets.

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<sup>2</sup> 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/Documents/oig11065%20\(508\).pdf](http://www.treasury.gov/about/organizational-structure/ig/Documents/oig11065%20(508).pdf).

Figure 1. Classified loans as of September 30, 2009<sup>3</sup> (in millions)



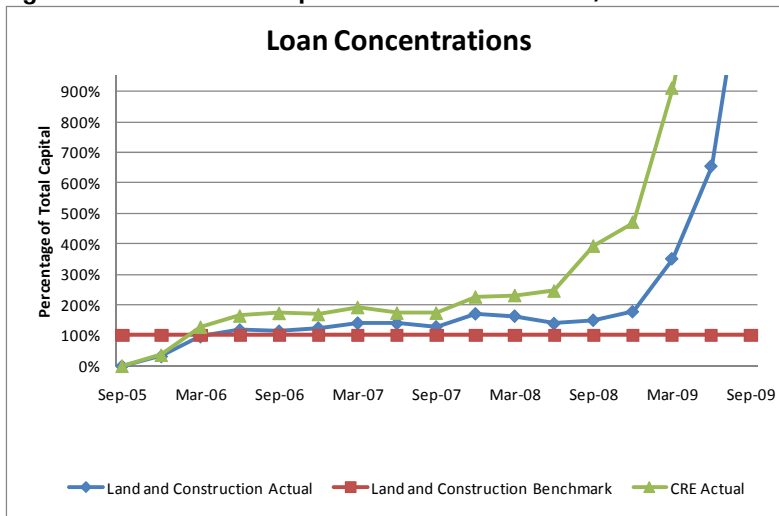
Source: OTS examination workpapers, 2009

In December 2006, OTS issued CEO Letter No. 252 which included OTS guidance entitled “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,” to clarify to its examiners that institutions actively engaged in commercial real estate (CRE) lending should (1) assess their concentration risk and (2) implement appropriate risk management policies to identify, monitor, manage, and control their concentration risks.

Partners primarily achieved loan growth through originations of real-estate related loans in the Naples and Collier County, Florida, area, including construction and land development loans, non-owner-occupied loans, and non-residential real estate loans. The growth in real estate loans coupled with the decline in capital levels led to higher levels of CRE concentration risk. Partners’ concentration of construction and land development loans was 119 percent of total capital at June 30, 2006, and 131 percent of total capital at September 30, 2007. Figure 2 shows Partners’ CRE loan portfolio concentrations throughout its history.

<sup>3</sup> The data is based on the original loan amount (\$17.3 million as opposed to the current amount outstanding of \$12.5 million) in order to reflect the loans that had been transferred to Real Estate Owned and did not have a current balance at September 30, 2009.

**Figure 2. Partners' loan portfolio concentrations, 2005-2009**



Source: Partners' Thrift Financial Reports (TFR) reports and OTS Universal Thrift Performance Reports.

### **Aggressive Underwriting Practices and Poor Risk Management**

Partners' TFRs reported deteriorating asset quality because of aggressive underwriting practices and poor risk management. OTS's November 2007 report of examination (ROE) noted that asset quality was less than satisfactory because of the downturn in the real estate market and aggressive loan underwriting by prior management, which resulted in a major increase in classified and nonperforming assets. OTS also noted that all of these loans included collateral valuations that were likely near the peak of the real estate market cycle and had limited borrower income verification.

During its loan review, OTS further noted exceptions to loan policies and risky credit practices. Examples of underwriting weaknesses found by OTS were loan-to-value ratios and debt-to-income ratios that exceeded the loan policies set by the board, loans to subprime borrowers, and policy exceptions that were not approved by the board. Furthermore, OTS noted that Partners' first president was the loan officer for several of the loans. In addition, OTS noted during its April 2006 field visit that the outstanding balances for loan and construction loans significantly exceeded board-approved loan portfolio diversification limitations. In response to examiner concerns, the board revised the loan portfolio limits in September 2006.

Independent internal asset and loan quality reviews obtained by Partners during March 2007 and February 2008 noted underwriting weaknesses at the thrift. The March 2007 report cited underwriting weaknesses in some of Partners' largest loans, some of which eventually became classified. The February 2008 report

noted certain information was not always available or not used when preparing a complete credit analysis. The independent reviewer observed weaknesses in the calculations of cash flows and tax returns that were not properly taken into consideration when preparing available debt coverage. It was also noted that the financial information was not current at the time the loans were underwritten. Furthermore, Partners' independent auditors noted that documentation supporting loan and deposit file maintenance was either missing or not normally retained.

Partners' poor asset quality resulted in an increased allowance for loan and lease losses (ALLL) and increased charge-offs of problem loans. Figure 3 details classified assets as a percentage of total loans.

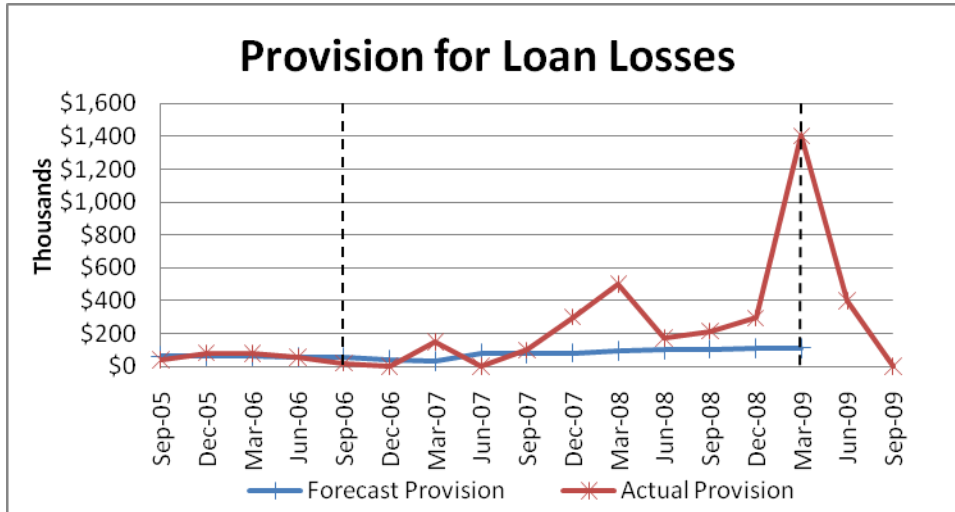
**Figure 3. Classified assets (in thousands)**

	6/30/2009	3/31/2009	12/31/2008	9/30/2007	6/30/2006
Classified assets	\$ 12,223	\$ 12,717	\$ 10,930	\$ 5,190	-
Total Loans	51,597	52,877	53,193	36,450	38,204
Classified assets to total loans	24%	24%	21%	14%	0%

Source: Reports on examinations and related workpapers.

Figure 4 presents the provision for loan and lease losses from September 30, 2005 through September 30, 2009. We noted that the provision for loan losses significantly exceeded the business plans from mid-2007 through March 31, 2009, the last date for which approved business plan metrics were available.

**Figure 4. Provision for loan losses**

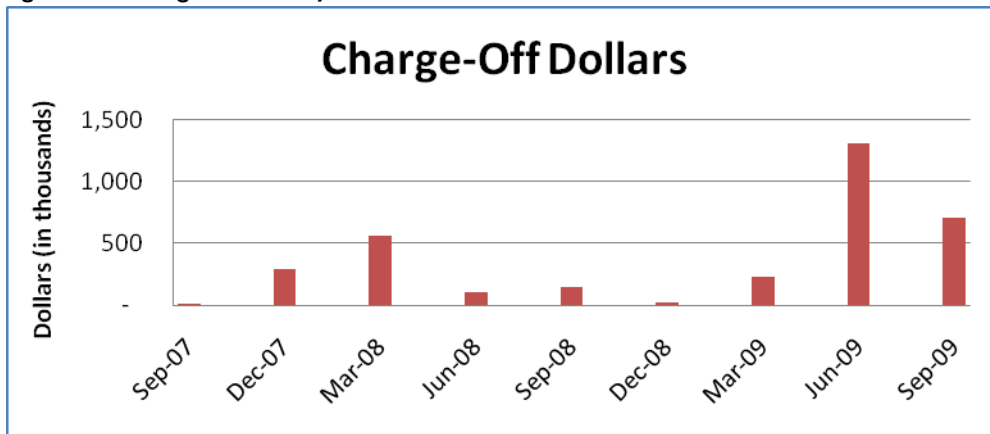


Source: Forecast 2005 and 2006 Business Plans; Actual: TFR data submitted by Partners.

Note: For the period September 2005 through September 2006, actual results are compared to the 2005 Business Plan. For the period December 2006 through March 2009, actual results are compared to the 2006 Business Plan. The approved business plans did not include metrics for the period April 1, 2009, through the receivership date.

Figure 5 presents charge-off dollars by quarter. Based on a review of Partners' TFRs, there were no charge-offs recorded prior to the September 2007 TFR.

**Figure 5. Charge-offs for years 2007-2009 (in thousands)**



Source: Partners TFRs for 2007-2009.

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The high levels of both provisions for loan losses and charge-offs are a direct result of the vintage of the loans and Partners' aggressive underwriting practices and poor risk management noted by OTS. The levels of provision for loan losses eroded Partners capital, and, ultimately, contributed to the failure of Partners.

### **Failure to Formulate and Execute a Viable Business Plan**

Partners was a de novo financial institution whose charter was approved in August 2005. As part of the charter approval process, Partners' management and board were required to submit a business plan. Based on 12 C. F. R. Part 543(c). Business Plan Requirements, because de novo federal associations have no operating or supervisory history, OTS believes that a thorough business plan is essential to ensuring that a de novo federal association will be operated in a safe and sound manner. In addition, Section 625 of the OTS Applications Handbook, Business Plan Guidelines, states that the business plan should be a comprehensive plan, which is the result of in-depth planning by the institution's organizers and management. The forecasts of market demand, customer base, competition, and economic conditions should be realistic.

As required, the organizers of Partners submitted a business plan which was reviewed and approved by OTS in August 2005 in connection with the granting of its charter.<sup>4</sup> This business plan included \$12 million of capital, an infrastructure that included one main office and a branch location, a loan portfolio that would include few speculative construction loans with most commercial loans being secured by real estate, and a local market focus (defined as Collier County, Florida). This business plan was acceptable to OTS and received OTS approval. Review of correspondence shows that within weeks of approval of the charter, the president of Partners conveyed to OTS that the organizers knew at the time of the filing of the charter that the business plan did not represent the strategic intent of the organizers of Partners and that Partners no longer considered the 2005 business plan to be viable. Once the issues with the business plan were revealed, OTS requested that Partners submit a modified business plan. In the meantime, OTS permitted Partners to continue to operate in a manner that significantly deviated from the approved 2005 business plan.

Partners' management submitted and OTS approved a second business plan in November 2006. The 2006 business plan included an increase in the concentration in higher-risk loans, an increase in out-of-market/nonlocal bank participation loans,

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<sup>4</sup> OTS Charter Approval Order Number 2005-32, dated August 18, 2005

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additional branching, and additional capital to support the increased risk and infrastructure costs.

Although Partners received OTS approval for its business plans in August 2005 and in November 2006, Partners was unable to perform in accordance with those approved business plans. For example, the November 2007 OTS ROE noted that Partners did not meet the projections of the 2006 business Plan mainly due to management turnover, the downturn in the real estate market and general economic environment in which Partners operated, and the abandonment of the branch expansion plans. In addition, by December 2007, Partners had determined that they would be unable to raise the additional capital and abandoned the additional branching strategy detailed in the 2006 business plan and developed a third business plan.

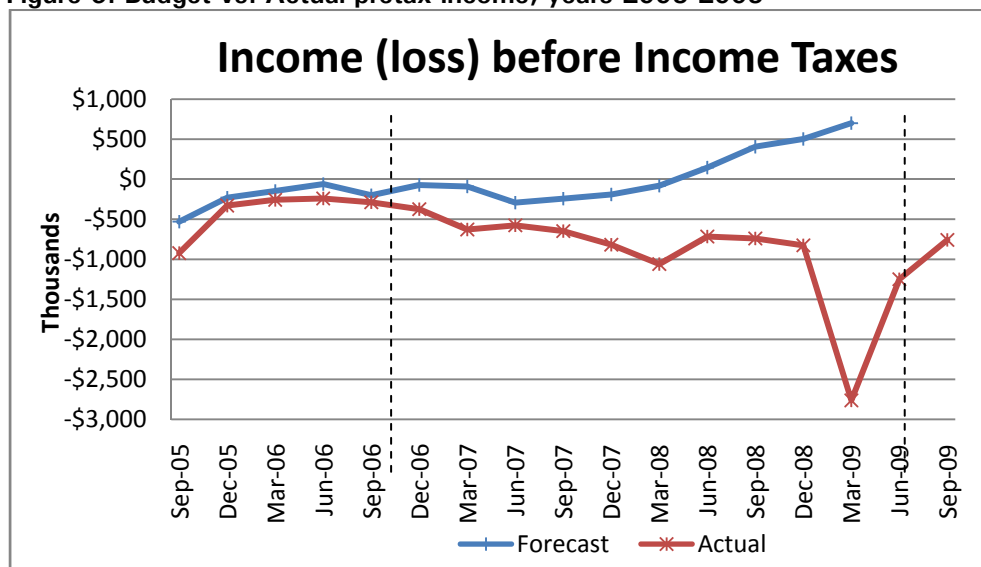
The third business plan was submitted to OTS in accordance with OTS Examinations Handbook Section 430 which requires that "associations must submit a revised business plan to the Regional Office if its projections change substantially." The third business plan deferred the additional branching and focused on significantly increasing loan originations and managing operating costs. Partners submitted that business plan for OTS approval in February 2008. OTS rejected that plan in March 2008 because the business plan was too aggressive and high risk.

Partners submitted a fourth business plan in April 2008, but in June 2008 requested that OTS disregard the business plan. As the revised business plans were not acceptable to OTS, Partners essentially operated without a business plan until its receivership in October 2009.



As figure 6 illustrates, Partners actual income (loss) before taxes was consistently below its approved business plan projections.

Figure 6. Budget vs. Actual pretax income, years 2005-2009



Source: Forecast – Partners’ 2005 and 2006 Business Plans; Actual – Partners’ TFRs  
 Note: For the period September 2005 through September 2006, actual results are compared to the 2005 Business Plan. For the period December 2006 through March 2009, actual results are compared to the November 2006 Business Plan. The approved business plans did not include metrics for the period April 1, 2009, through the receivership date.

In addition to Partners’ inability to adhere to the financial projections included within their approved business plans, OTS noted that Partners had noninterest expense that was in excess of peer banks. The March 2009 ROE noted that general and administrative expenses remained high and were the largest contributing factor to core losses year over year. For the calendar year ended December 31, 2009, general and administrative expenses represented 5.3 percent of average assets, while the peer group median was 2.7 percent.

The decline in the economic environment combined with Partners’ inability to formulate and adhere to a clear, comprehensive, coherent strategy and related business plan resulted in a lack of strategic direction which ultimately led to losses that eroded Partners capital and contributed to Partners’ failure.

### Poor Management and Board Oversight

Partners did not have effective or consistent management and board oversight. During interviews with OTS Southeast Region supervisory staff and the Federal Deposit Insurance Corporation (FDIC)-Division of Resolution and Receiverships, OTS

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and FDIC representatives we interviewed commented that Partners' first president and first senior credit officer/chief lending officer were responsible for making many of the decisions that led to the failure of Partners.

During its 4 year operating history, Partners' president, chief lending officer, and chief financial officer resigned and were replaced. In addition, one director resigned and was not replaced. The majority of these resignations occurred during 2007.

In the November 2007 ROE, OTS noted that the unsuccessful execution of the OTS-approved business plans and the less than satisfactory overall financial condition reflected poorly on the board's oversight and management's performance. OTS also noted that Partners' financial condition was less than satisfactory and a regulatory concern. Partners lacked direction and effective management, and asset quality was less than satisfactory. Furthermore, OTS noted that the entire senior management team, including the president, a director, and several other employees resigned since the prior examination.

### **Inadequate Capital Levels**

Partners incurred operating losses from the time it opened in 2005 through its closure in 2009. Declining asset quality caused capital to steadily decrease. Within only 6 months, the operating losses eroded Partners' capital from being well-capitalized at December 31, 2008, to critically undercapitalized at June 30, 2009. The following table shows Partners' capital ratios and the dates of significant regulatory actions by OTS from December 2008 to October 2009.

**Figure 7. Partners' Capital Levels**

Date of Report	Capital Ratio (Percent)			Regulatory Capital Category*
	Total-Risk Based	Tier 1 / Risk-Based	Tier 1 / Leverage (and tangible equity)	
12/31/2008	11.28%	10.03%	7.17%	Well Capitalized
3/31/2009**	6.00%	4.74%	3.42%	Undercapitalized
4/21/2009	OTS notified Partners of its <u>Troubled Condition</u>			
6/30/2009	3.54%	2.29%	1.70%	Critically undercapitalized
8/21/2009	OTS issued a <u>Cease and Desist (C&amp;D)</u> order			
9/18/2009	OTS issued a PCA directive			
9/30/2009	1.60%	0.80%	0.63%	Critically undercapitalized
* Thrifts must maintain a minimum Total <u>Risk-Based Capital</u> ratio of 10 percent, Tier 1 Risk-Based Capital Ratio of 6 percent, and Tier 1 Leverage Capital Ratio of 5 percent to be considered well-capitalized.				
** TFR was amended on 8/11/2009 as a result of the OTS examination. Significant adjustments were made to the allowance for loan losses and related provision for loan losses as a result of the March 2009 OTS examination.				
Sources: TFR and ROE.				

As shown in Figure 7 above, by March 31, 2009, Partners was unable to maintain the capital levels required by OTS to remain well or adequately capitalized. Net operating losses attributed primarily to the provision for loan losses charged to earnings was the primary reason Partners was unable to maintain the required capital levels.

## OTS's Supervision of Partners

The OTS supervision of Partners was inconsistent throughout Partners' existence. OTS did not act on situations calling for more timely supervision and stronger enforcement actions earlier.

## Summary of OTS's Supervisory Actions of Partners

Table 1 summarizes the results of OTS's safety and soundness full-scope and limited-scope examinations of Partners from 2006 until its closure in October 2009. Generally, matters requiring board attention (MRBAs) represent the most significant items reported in ROEs requiring corrective action.

Table 1. Summary of OTS's Examinations of and Enforcement Actions Against Partners					
Examination Results					
Date started/date mailed	Total assets (in millions) at the time of examination	CAMELS rating	Number of MRBA	Number of corrective actions	Formal Actions
04/24/2006 06/29/2006	\$24	Limited exam to review policies and procedures, financial condition, asset quality and credit administration, compliance with the conditions of the OTS Charter Approval Order, compliance with the OTS-approved 3-year de novo business plan, and performance of management and the directorate.			None
08/31/2006 11/03/2006	\$51	2/222222	1	5	None
11/30/2007 02/22/2008	\$59	3/233322	3	10	None
01/28/2008 01/28/2008	\$59	Limited exam: <u>CAMELS</u> composite rating downgraded from 2 to 3. Downgraded CAMELS asset quality, management, and earnings ratings from 2 to 3. *			
03/23/2009 07/10/2009	\$76	5/553542	8	17	Notice of "Troubled Condition" and supervisory restrictions, effective 4/21/2009 C&D order, effective 8/21/2009 PCA directive, effective 9/18/2009
* An offsite limited-scope examination was conducted by the OTS prior to the issuance of the November 30, 2007 ROE. As this limited-scope examination was completed prior to the November 30, 2007, this examination officially downgraded Partners from CAMELS composite 2 to CAMELS composite 3.					

Source: OTS ROEs and notices.

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## OTS Failed To Enforce Conditions of the Charter Approval Order

One of the conditions of the thrift charter approval order for Partners states:<sup>5</sup>

*“The Savings Bank must operate within the parameters of its three-year business plan. The Savings Bank must submit for the prior, written non-objection of the Regional Director, any proposed major deviations or material changes from the plan. The request for change must be submitted no later than 60 calendar days prior to the desired implementation date with a copy sent to the FDIC Regional Office. ”*

In conjunction with the approval of the thrift charter application, Partners was required to comply with all the conditions of their application approval. Administration section 080 of the OTS Examination Handbook states that if there are violations of any condition OTS imposed in writing in connection with the granting of any application or other request by the association, OTS can assess civil money penalties, and if additional conditions are met, can issue orders of removal and prohibition.

As discussed above, our review of correspondence revealed that within weeks of approval of the charter, the president of Partners conveyed to OTS that the organizers knew at the time of the filing of the charter that the business plan included in the charter application did not represent the strategic intent of the organizers of Partners and that Partners no longer considered the 2005 business plan to be viable. Partners also noted that they were deviating from the business plan approved in the charter application. In addition, in quarterly business plan variance reports prepared by OTS for Partners’ first year of operation, OTS noted that Partners was operating well outside its business plan parameters. Furthermore, OTS’s April 2006 ROE indicated that OTS was aware that Partners’ management had determined that the 2005 business plan was not viable, drafted a revised business plan to be submitted to OTS, and was deviating from the approved business plan. Subsequently, the August 2006 ROE indicated that adherence to the approved business plan had been a challenge, and there were several noticeable variances.

Although OTS was aware that Partners was not in compliance with the condition of operating within the parameters of its 3-year business plan, OTS did not take appropriate action. Through discussions with OTS regional examination staff, OTS noted that examiners considered taking enforcement action, but determined that

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<sup>5</sup> OTS Charter Approval Order Number 2005-32, dated August 18, 2005

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reminding Partners of the requirement to maintain and adhere to a business plan that was representative of their strategic intent and allowing Partners to submit an updated business plan was appropriate, despite the fact that more severe action could have been taken.

### **OTS Did Not Accurately Rate Partners' Asset Quality, Management, and Earnings CAMELS Components**

OTS's first comprehensive full scope examination, dated August 31, 2006, resulted in a composite CAMELS and component ratings of 2/222222. However, based on the factors discussed below, we believe OTS had sufficient evidence to support a 3 rating related to the asset quality, management, earnings CAMELS components. The assignment of CAMELS ratings is a judgmental process that requires examiners to consider all of the objective and subjective variables, concepts, and guidelines discussed in OTS's Examination Handbook.

An asset quality rating of 3 is to be assigned when: asset quality or credit administration practices are less than satisfactory; trends may be stable or indicate deterioration in asset quality or an increase in risk exposure; the level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern; and there is generally a need to improve credit administration and risk management practices. Partners' portfolio composition and concentrations in high-risk lending supported a more severe asset quality rating than the 2 rating assigned by OTS during the examination. In the August 2006 ROE, OTS noted that the April 2006 field visit disclosed that the outstanding balances for land and construction loans significantly exceeded the board-approved limitations. In response to examiner concerns, rather than address the asset composition, the board merely approved revised loan portfolio limits in September 2006, which allowed the composition at August 2006 to be in compliance with board-mandated limits. In addition, Partners submitted a business plan with the charter application that noted Partners would originate little, if any, speculative-type loans due to the high risk involved in these types of loans. However, at June 30, 2006, approximately half of the outstanding balance of construction loans were speculative residential loans.

A management rating of 3 is to be assigned when: management and board performance needs improvement or risk management practices are less than satisfactory given the nature of the institution's activities; the capabilities of management or the board may be insufficient for the type, size, or condition of the institution; and problems and significant risks may be inadequately identified, measured, monitored, or controlled. The assignment of ratings is a judgmental

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process and while OTS noted in the August 2006 ROE that management had operated the bank in a safe and sound manner, the management team was considered knowledgeable and capable, and the board had provided satisfactory oversight, OTS had evidence that management misrepresented their strategic intentions in their charter application, which we believe supported the consideration of a more severe rating for the Management component.

An earnings rating of 3 is to be assigned when earnings need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings. In the August 2006 ROE, OTS noted operating performance had been well short of business plan projections. Most notably, actual noninterest expenses were higher than planned because management underestimated pre-opening expenses by 25 percent. Actual interest expense exceeded the plan projections by 144 percent. Actual noninterest income was 78 percent lower than planned because of weak residential mortgage origination income, which resulted in lower income from fees and the sale of loans.

In addition to supporting a 3 rating in asset quality, management, and earnings, taken together, we believe this evidence supports a composite CAMELS rating of 3 in 2006.

In interviews with OTS regional examination staff, OTS noted that in general the 2 CAMELS composite rating was supported by the following facts:

- Partners' operations were proceeding more or less in accordance with the business plan;
- Partners' was attracting business at the planned rate; and
- Partners' capital was at the planned level.

Although these considerations were factored into OTS's assignment of the CAMELS composite rating of 2, OTS should have compared such facts to the considerations noted in the ratings definitions included in the OTS Examination Manual.

### **OTS Failed to Enforce Conditions of the Branch Application Approval**

In November 2006, Partners applied to OTS for 3 additional branch locations. Included within that application was a revised business plan. The revised business plan noted that Partners Financial Corporation, Partners' holding company, would raise \$12 million in additional capital, part of which would be infused into Partners

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to support the resulting increased infrastructure costs related to three new planned branches and the increased risk profile of the loan portfolio.

The OTS Applications Processing Handbook states that OTS should consider the following factors in analyzing a branch application to determine if the branch activity satisfies the applicable regulatory criteria for approval:

- Will the institution meet the minimum regulatory capital requirements of 12 C.F.R. § 567.2, except as otherwise permitted under section 38(e)(4) of the FDIA, and be adequately capitalized under the PCA guidelines (12 C.F.R. Part 565)?
- Will the new branch office have an adverse effect on the operations of the institution (fixed asset investment, projected savings growth, earnings)?

In a November 30, 2006, letter to Partners approving the branch application and the revised 2006 business plan, OTS noted that it is incumbent upon management and the directorate that Partners operate within the parameters of this revised business plan, and any material variances therein must be communicated to OTS, with any requested changes submitted no later than 60 calendar days prior to the desired implementation date.

While the \$12 million in additional capital was projected within the 2006 business plan, and considered by OTS during their branch application approval process, OTS did not require Partners Financial Corporation to raise the capital prior to Partners moving forward with plans to open the new branches. Partners Financial Corporation did not raise the \$12 million capital, but did enter into leases and incurred expenses related to the planned branch expansion.

Based on the OTS Applications Processing Handbook, OTS could have added an additional capital as a condition to the branch application approval, as the capital was necessary to support the increased infrastructure costs from the branch expansion and the risk profile of its loan portfolio. Had OTS required Partners to raise the additional capital prior to moving forward with the branch expansion plan, Partners may have raised additional capital, which could have reduced the loss to the Deposit Insurance Fund.

Additionally, in its 2007 business plan, submitted to the OTS for approval in early 2008, Partners stated that due to the deterioration of the economy in Partners' service area during the latter half of 2006 and 2007, and in particular the housing market, Partners' deferred its plan to increase its branch network and, Partners Financial Corporation did not sell additional shares of its common stock and, as a result, did not infuse additional capital into Partners.



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As noted above, noncompliance with the approved business plan is a condition that could warrant formal or informal enforcement actions by OTS. OTS did not issue formal or informal enforcement actions related to this noncompliance with the approved business plan.

### **OTS Failed to Issue an Informal Enforcement Action When Partners Was Classified as a Composite 3-rated Institution**

The November 2007 ROE (full scope examination) and the January 2008 ROE (limited scope examination) resulted in Partners' CAMELS composite, asset quality, management, and earning ratings being downgraded to 3s. However, OTS did not issue an enforcement action as suggested by its guidance in place at the time.

During this timeframe, Administration Section 080 of the OTS Examination Manual stated that:

*"There is a presumption that savings associations with a composite rating of 3 for the latest safety and soundness, compliance, trust, or information technology examination warrant formal enforcement action under any of the following circumstances:*

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

*OTS may consider issuing an informal enforcement action for a 3-rated association with strong management and a generally positive assessment if circumstances suggest that remedial measures are immediately forthcoming. The capability, cooperation, integrity, and commitment of management, board, and owners are important considerations in choosing the appropriate actions. "*

In the November 2007 ROE and January 2008 ROE, OTS noted that the conditions that resulted in the ratings in the asset quality, management and earnings components, were related to decisions made by the initial management of Partners.

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OTS also noted that Partners lacked direction and effective management. Considering the management component rating as well as the comments regarding the management of Partners, formal enforcement action could have been warranted based on the guidance discussed above.

Partners received a CAMELS composite 3 rating, which included a management component rating of a 3, if formal enforcement action was not deemed necessary, OTS should have, at a minimum, considered an informal enforcement action based on the above guidance. However, OTS did not take any formal or informal enforcement action in conjunction with the issuance of the ROEs that resulted in a CAMELS composite 3 rating. OTS noted in an interview that they informed Partners' management that there would be enforcement action during the next examination if the CAMELS ratings did not improve.

The OTS guidance discussed above was revised in its July 18, 2008 update to the OTS Examination Manual as follows:

*“There is a presumption that savings associations or holding companies with a composite examination rating of 3 warrant informal enforcement action. Although failure appears unlikely given the association’s overall strength and financial capacity, 3-rated institutions require more than normal supervision and an informal enforcement action is presumed necessary.”*

OTS noted in an interview that enforcement action, formal or informal, was not taken due to a change in management and an announced change in the business plan. In July 2007, a new chief executive officer (CEO) had been hired and Partners was in the process of replacing other members of executive management. OTS described the new CEO as an experienced banker that was capable of implementing an updated business plan that would improve the performance of Partners. However, the new CEO had been in place 5 months before the examination date and was in place throughout the course of the examination, thus the new management would have been considered by OTS in determining the management component rating included within the November 2007 and January 2008 ROEs.

During our interview with OTS Southeast region supervisory staff, OTS indicated that current practice for an institution that is rated CAMELS composite 3 is for OTS to complete a site visit or limited-scope examination on a 6-month basis. However, OTS indicated that they did not complete a site visit or limited-scope examination because Partners recently hired new management.

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## OTS's Use of Prompt Corrective Action

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term loss to the Deposit Insurance Fund. 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 levels to help reduce deposit insurance losses caused by unsafe and unsound practices.

Partners' capital levels deteriorated rapidly. Partners was considered *Well Capitalized* for PCA purposes as of December 31, 2008; *Undercapitalized* for PCA purposes as of March 31, 2009; and *Critically Undercapitalized* for PCA purposes as of June 30, 2009.

OTS followed its PCA implementation guidance with respect to Partners, with the exception of one instance where OTS did not provide a timely notice of intent to issue a PCA directive stating that the bank had failed to submit a capital restoration plan. As a result of the March 23, 2009, examination, OTS required Partners to amend their TFR to reflect adjustments noted as part of the examination process. Once the true financial condition of Partners was known, OTS implemented PCA as described below.

- Partners reported that they were adequately capitalized with a \$1.0 million net loss in the quarter ending March 2009; however, OTS identified additional losses totaling \$1.1 million and required Partners to amend its TFR as of March 31, 2009. The amended TFR reported that Partners was undercapitalized by PCA standards as of March 31, 2009.
- On July 13, 2009, OTS issued a supervisory directive that served to (1) notify Partners of its undercapitalized status; (2) require the submission of a capital restoration plan no later than August 26, 2009; and (3) require Partners to abide by mandatory PCA restrictions. The PCA mandatory restrictions included restrictions on the following:
  - capital distributions;
  - the payment of management fees;
  - growth in average total assets;
  - acquiring an interest in any company or insured depository institution or the establishment of any additional branch offices; and
  - restrictions on increases in the use of brokered deposits<sup>6</sup>.

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<sup>6</sup> An institution that is undercapitalized is prohibited from accepting, renewing or rolling over any brokered deposits under 12 CFR 337.6.

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- On July 30, 2009, OTS determined that Partners was critically undercapitalized under PCA standards based on Partners June 30, 2009 TFR. On August 3, 2009, OTS notified Partners that its PCA capital category had deteriorated to critically undercapitalized and required Partners to submit a capital restoration plan and to abide by the mandatory PCA restrictions set forth in the July 13, 2009 directive. On August 6, 2009, OTS notified Partners that it was required to submit its capital restoration plan not later than August 17, 2009, more than a week sooner than required by the July 13, 2009 supervisory directive.
  - On August 12, 2009, Partners' board submitted a letter to OTS noting that no capital restoration plan would be forthcoming. OTS's PCA guidance requires that a notice be submitted to an institution within 15 days of reviewing and either approving or denying an institution's capital restoration plan. Since Partners indicated that they would not be providing a capital restoration plan and thus, there is no plan to review, the date of the receipt of the letter should be considered the date of the denial of the capital restoration plan. Using August 12, 2009 as the denial date, OTS guidance called for a notice of intent to issue a PCA directive to be issued by August 27, 2009; however, OTS did not issue such notice until September 8, 2009, 11 days later.<sup>7</sup>
  - On September 8, 2009, OTS issued a notice of intent to issue a PCA directive notifying Partners that (1) Partners had failed to file an acceptable Capital Restoration Plan; and (2) OTS requested that Partners' board consent to a PCA Directive and a Stipulation and Consent to PCA Directive (Stipulation). The Stipulation included a provision that Partners consented to OTS's appointment of a conservator or receiver for Partners.
  - On September 18, 2009, the PCA directive and Stipulation became effective after Partners' board of directors consented to its issuance. Partners' board of directors consented to OTS's appointment of a receiver.
  - On September 22, 2009, OTS issued the final PCA directive with a September 18, 2009 effective date.
  - On October 19, 2009, Partners' board confirmed its intention to consent to the PCA directive in a Board Resolution.
  - On October 23, 2009 OTS closed Partners and placed Partners into FDIC receivership.

The PCA, Stipulation, and C&D order taken by OTS ultimately were unsuccessful to prevent Partners' failure or a material loss to the Deposit Insurance Fund.

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<sup>7</sup> OTS Examination Handbook, Section 080, Appendix A, Enforcement Actions.

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## OTS's Internal Failed Bank Review

In accordance with OTS Policy, an internal review of Partners' failure was performed to determine the causes of failure, evaluate the supervision exercised by OTS, and provide recommendations based upon the findings of the review.<sup>8</sup> The OTS review, completed in April 2010, determined that Partners' failure resulted from high levels of problem assets that steadily eroded capital. Partners' deteriorating asset quality and continuing significant operating deficiencies eliminated any prospective acquirers or merger partners in order to recapitalize Partners Financial Corporation and Partners. The OTS review noted that concentrations of risk were also a contributor to Partners' failure.

The OTS review identified the following two areas where OTS supervision should have been more effective:

1. OTS should have been more aggressive in resolving the viability of the approved business plan and the viability of the institution if the board failed to raise the additional \$12 million in new capital. OTS's supervisory response should have also set limits on any further lending until a viable business plan had been approved and any additional capital had been raised.
2. OTS' supervisory response should have been more aggressive given the noted lack of direction, numerous changes in the management structure, continued inability to adhere to an approved business plan, and less than satisfactory asset quality.

The OTS internal review also made two recommendations to OTS:

1. OTS should be more aggressive in its supervisory approach when a de novo institution deviates from its approved business plan. More aggressive supervision is especially warranted if after commencing operations OTS becomes aware that the approved business plan was never the business plan the organizers planned to pursue. Informal enforcement action, at a minimum, should be pursued when any material deviations occur from an approved business plan.

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<sup>8</sup> OTS policy requires that an internal assessment be conducted when a thrift fails. That assessment, referred to as an internal failed bank 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 Western Region initiated an internal review of Partners following its failure in October 2009. The scope of the review focused on OTS's supervision from the application process in 2005 to Partners' closure on October 23, 2009.

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2. OTS should consider higher capital requirements as well as absolute limitations of high-risk-lending concentrations.<sup>9</sup>

Based on our review of the examination records and reports and interviews with OTS staff, we affirm OTS's internal findings and the need for corrective action.

## Recommendations

We recommend that OTS

1. Take action on OTS's internal failed bank review of Partners.
2. Ensure supervisory staff enforce compliance with conditions of approved charters.
3. Caution supervisory staff to exercise OTS's discretion to impose additional conditions when approving modifications to an existing approved business plan, particularly when management does not fully comply with the original business plan.
4. Caution supervisory staff to consider whether additional capital should be required and in place prior to permitting an institution to proceed with a business plan that requires additional capital, and
5. Remind supervisory staff to consider OTS guidance regarding informal enforcement action when a bank is 3-rated.

## Management Response to Recommendations

In a written response, presented as Attachment 3 to this report, OTS acknowledged and concurred with our conclusions and recommendations in the report. OTS believes the policies, procedures and guidance it has put in place address the recommendations contained in the report.

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<sup>9</sup> OTS previously addressed this recommendation through OTS's CEO letter 311, Risk Management: Asset and Liability Concentrations, issued on July 9, 2009.

## Objectives

We performed this performance audit under a contract with the Department of the Treasury Office of Inspector General (OIG) to satisfy the requirements in section 38(k) of the Federal Deposit Insurance (FDI) Act,<sup>10</sup> which provides, in general, that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency that:

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

At the time Partners Bank (Partners) failed on October 23, 2009, Section 38(k) of the FDI Act defined a loss as material if it exceeds the greater of \$25 million or 2 percent of the institution's total assets.<sup>11</sup> The FDI Act also requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred. The requirement for the performance of a material loss review under section 38 was based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of May 26, 2011, FDIC estimated that Partners' loss to the Deposit Insurance Fund was \$34.6 million.

Our audit objectives were to (1) determine the causes of Partners' failure and resulting material loss to the DIF, (2) evaluate the Office of Thrift Supervision's (OTS) supervision of the institution, including the implementation of the PCA provisions of section 38, and (3) make recommendations for preventing any such loss in the future.

We conducted this performance audit from January 2010 to August 2010 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

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<sup>10</sup> 12 U.S.C. § 1831o(k).

<sup>11</sup> P.L. 111-203, enacted on July 21, 2010, changed the definition of material loss in section 38(k) to any estimated loss in excess of \$200 million for a loss occurring in 2010 and 2011, \$150 million for a loss occurring in 2012 and 2013, and \$50 million for a loss occurring in 2014 or after (with a provision for a temporary increase to \$75 million if certain conditions are met).

obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Scope and Methodology

The scope of this audit included an analysis of Partners from August 25, 2005 until its failure on October 23, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

To achieve the objectives, we performed the following procedures and utilized the following techniques:

- Analyzed examination reports, supporting workpapers, and related supervisory and enforcement correspondence prepared by OTS examiners from April 2006 to March 2009.
- Analyzed OTS's internal assessment of Partners' failure.
- Reviewed the following documentation:
  - Partners' data and correspondence maintained by OTS's Southeast Regional Office in Atlanta, as provided to us by OTS.
  - Reports prepared by the Federal Deposit Insurance Corporation (FDIC) Division of Resolutions and Receiverships (DRR) and Division of Supervision and Consumer Protection (DSC).
  - Pertinent OTS policies and procedures.
- Interviewed the relevant OTS officials having supervisory responsibilities pertaining to Partners, which included OTS examination staff in the Southeast Region to discuss the historical perspective of the institution, its examinations, and other activities regarding the supervision of Partners.
- Interviewed the relevant FDIC officials having involvement in the receivership of Partners.

We relied primarily upon materials provided by OTS and FDIC DRR, including information and other data collected during interviews. We did not perform specific audit procedures to ensure the information and data were complete and accurate.

We are, however, aware that Treasury Order 114-01, dated May 16, 1989, requires that all Treasury officers and employees cooperate with the Treasury OIG in order for the OIG to carry out its statutory mandate. To that end, no officer or employee shall:



- a. prevent the Inspector General from initiating, carrying out, or completing any audit or investigation, or from issuing any subpoena during the course of an audit or investigation, except that the Inspector General shall be under the authority, direction, and control of the Secretary and the Deputy Secretary of the Treasury with respect to matters set forth in Section 8C(a) of the Inspector General Act, as amended.
- b. prevent or prohibit any duly appointed officer or employee of the Office of Inspector General from obtaining access to any information or documentation which the Inspector General has determined is necessary to the execution of an audit, investigation or other inquiry, except that the Inspector General shall be under the authority, direction, and control of the Secretary and the Deputy Secretary of the Treasury with respect to matters set forth in Section 8C(a) of the Inspector General Act, as amended.

Interviews were conducted to gain a better understanding of decisions made regarding the supervisory approach to the institution and to clarify information and conclusions contained in the reports of examination (ROEs) and other relevant supervisory correspondence between OTS and Partners. We relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

### **Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance with Laws and Regulations**

Consistent with the audit objectives, we did not assess OTS's overall internal control or management control structure. We relied on information in OTS systems, reports, ROEs, and interviews of examiners to understand Partners' management controls pertaining to causes of failure and material loss as discussed in the body of this report.

We obtained data from various OTS systems but determined that information system controls were not significant to the audit objective and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including ROEs, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a consumer-focused strategic plan, align agency programs and activities with concrete missions and goals,

and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of OTS's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives.

Regarding compliance with laws and regulations, we performed tests to determine whether OTS has complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests are discussed, when appropriate, in this report. Additionally, we assessed the risk of fraud and abuse related to our audit objectives in the course of evaluating audit evidence.

## **Partners Bank History**

An application was filed on behalf of Partners Financial Corporation (PFC) to acquire control of Partners Bank (Partners) in connection with the de novo application filing for Partners on October 20, 2004. The Office of Thrift Supervision (OTS) approved the application on August 18, 2005, and Partners was chartered as a Savings Bank on August 24, 2005. Partners' primary operation was originating loans, including residential mortgage loans and nonresidential, construction, and commercial loans, and taking deposits. Partners' beginning asset balance was over \$8 million and was projected to grow to \$91 million by its third year of operation. It was also projected to sustain net losses in its first 2 years of operation, but to record net income of \$370 thousand by year 3. However, this did not come to pass, and Partners sustained net losses in each year of operation until its closing in 2009.

Partners opened with an office in Naples, Florida. In September 2006, Partners submitted an application to open three additional branches, including a new headquarter office in Naples, and an expansion into Everglades City, Florida. At that time, Partners' submitted a revised business plan to OTS that called for \$12 million of additional capital to be infused into Partners in order to support the new branches. In early 2007, the chairman and CEO of Partners and PFC resigned. Partners and PFC appointed a new president and CEO later in 2007, but Partners continued to experience turnover among the management group as Partners continued incurring operating losses and capital erosion through 2009. On October 23, 2009, OTS closed Partners and appointed FDIC as receiver. At the time of closing, Partners had assets of \$63.4 million.

## **Types of Examinations Conducted by OTS**

OTS conducts various types of examinations including safety and soundness and compliance. These come in the form of both limited-scope examinations and full-scope examinations. OTS must conduct a full-scope examination of insured thrifts either once every 12 months or once every 18 months. During a full-scope exam, the examiners conduct an on-site examination and rate all CAMELS components. OTS then assigns each thrift a CAMELS composite rating based on its assessment of the overall condition and level of supervisory concern.

OTS uses the 12-month cycle until a thrift's management has demonstrated its ability to operate the institution in a safe and sound manner and has satisfied all conditions imposed at the time of approval of its charter. The 12-month examination cycle is applied to de novo institutions.

## **Enforcement Actions Available to OTS**

OTS examinations of thrifts result in the issuance of reports of examinations (ROE) identifying areas of concern. OTS uses informal and formal enforcement actions to address violations of laws and regulations and to address unsafe and unsound practices.

### Informal Enforcement Actions

When a thrift's overall condition is sound, but it is necessary to obtain written commitments from a thrift's board of directors (board) or management to ensure that it will correct identified problems and weaknesses, OTS may use informal enforcement actions. OTS commonly uses informal 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 that warrant attention. A record of informal action is beneficial in the event that formal action is necessary later.

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 action against a noncompliant thrift. The effectiveness of informal action depends in part on the willingness and ability of a thrift to correct deficiencies that OTS notes. Informal enforcement actions include supervisory directives, memoranda of understanding, and board resolutions.

### Formal Enforcement Actions

If informal tools do not resolve a problem that has been identified, OTS is to use formal enforcement tools. 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 is to use 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 the 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 may 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, and ownership to correct identified problems;
- the effect of the illegal, unsafe, or unsound conduct on other financial institutions, depositors, or the public;
- the examination rating of the thrift;
- whether the thrift's condition is improving or deteriorating; and
- the presence of unique circumstances.

### **OTS Assessments Paid by Partners**

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 its 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 by the amounts by which an association exceeds each threshold. Table 2 shows the assessments that Partners paid to OTS from 2005 through 2009.

**Table 2: Assessments Paid by Bank to OTS, 2005–2009**

<b>Billing Period</b>	<b>Exam Rating</b>	<b>Amount Paid</b>
1/1/2006–6/30/2006	N/A	\$ 5,172
7/1/2006–12/31/2006	N/A	\$10,662
1/1/2007–6/30/2007	2	\$11,534
7/1/2007–12/31/2007	2	\$13,727
1/1/2008–6/30/2008	3	\$19,700
7/1/2008–12/31/2008	3	\$20,018
1/1/2009–6/30/2009	3	\$22,880
7/1/2009–12/31/2009	5	\$30,966
<b>Total</b>		<b>\$134,659</b>

Source: OTS.

### Number of OTS Staff Hours Spent Examining Bank

Table 3 shows the number of OTS staff hours spent examining Bank from 2005 to 2009.

**Table 3: Number of OTS Hours Spent on Examining Bank, 2005-2009**

<b>Examination Start Date</b>	<b>Type of Examination</b>	<b>Number of Examination Hours*</b>
4/24/2006	Limited-scope	311
8/31/2006	Full-scope	319
11/30/2007	Full-scope	499
3/23/2009	Full-scope	1,264
<b>Total</b>		<b>2,393</b>

Source: OTS

\*Hours are totaled for safety and soundness examinations, information technology examinations, and compliance examinations.



**Office of Thrift Supervision**

Department of the Treasury

Thomas A. Barnes  
*Deputy Director, Examinations, Supervision, and Consumer Protection*

1700 G Street, N.W., Washington, DC 20552 • (202) 906-5650

July 12, 2011

**MEMORANDUM FOR:** KPMG, LLP on behalf of Treasury Office of Inspector General

**FROM:** Thomas A. Barnes /s/  
Deputy Director

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

Thank you for the opportunity to comment on the draft Material Loss Review Report (Report) for Partners Bank prepared by KPMG, LLP for the Department of the Treasury Office of Inspector General (OIG). The Report concluded that Partners failed because of loan concentrations in real estate related loans originated in Naples and Collier County Florida during the peak of the market, and aggressive loan underwriting and poor risk management practices at the bank. The Report also concluded that Partners failed to formulate and execute a viable business plan providing for adequate capital levels. These factors, combined with the rapid decline in the economic environment, resulted in the deterioration of the bank's asset quality and loan losses. Poor management and board oversight also contributed to the bank's failure.

The Report recommends that OTS take action as indicated in its internal failed bank review. The Report further recommends that OTS supervisory staff enforce compliance with charter approval conditions and exercise discretion to impose additional conditions when approving modifications to an existing approved business plan, particularly when management has not fully complied with the original business plan. OTS supervisory staff should be cautioned to consider whether additional capital should be in place prior to permitting an institution to proceed with a business plan that requires additional capital. Finally, Supervisory staff should be reminded to comply with OTS guidance regarding informal enforcement action when a bank is composite 3-rated.

We acknowledge and concur with the conclusions and recommendations in the Report.

We believe the policies, procedures and guidance OTS has put in place address the recommendations contained 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.

## **Section II**

### **Report Distribution**



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