DECISION OF THE
ASSESSMENT APPEALS COMMITTEE

CASE NO. 2009-02

SUMMARY OF FINDINGS

This appeal arises from a disputed Supervisory Group assignment for the quarterly assessment period ending September 30, 2008. ***, *** (the "Bank,") challenged the determination of the FDIC's Division of Insurance and Research ("DIR") denying the Bank's January 12, 2009 request to upgrade its supervisory evaluation from Supervisory Group "C" to Supervisory Group "B" for the July 1, 2008 through September 30, 2008 quarterly assessment period. The requested upgrade would have placed the Bank in Risk Category II for the assessment period, subject to an annual assessment rate of 10 basis points rather than in Risk Category III called for by a Supervisory Group "C" assignment. As a Risk Category III institution, the Bank was assessed at a 28 basis-point annual rate, resulting in a quarterly deposit insurance assessment of $143,213.54, or $91,705.29 higher than had the Bank been upgraded to Supervisory Group "B."

At its meeting held on June 2, 2009 and based on the submissions of the parties, the Committee has determined to deny the Bank's appeal and uphold DIR's supervisory evaluation as properly denoting the institution's financial condition, as well as the risk it poses to the Deposit Insurance Fund.

BACKGROUND

On January 12, 2009, the Bank challenged its Risk Category III designation by contending that its Supervisory Group "C" assignment was unfounded and unsupported (the "Request for Review"). The Bank argued that the findings of the Bank's safety and soundness Report of Examination ("ROE") do not support a Supervisory Group "C" classification under which an institution is found to "pose a substantial probability of loss to the deposit insurance fund." 12 C.F.R. § 327.9(c)(3). Rather, the Bank asserted, the CAMELS rating of "4" describes an institution considered merely to pose a "risk" to the deposit insurance fund (the "DIF").

By letter of March 10, 2009, DIR denied the Request for Review, explaining that the Bank's supervisory and risk assignments were appropriate and consistent with the assessments regulations and the guidance available in the FDIC's Financial Institution Letters ("FILs") and on its assessment website. The denial further noted that assignment of institutions with CAMELS composite ratings of "4" to Supervisory Group "C" has been a longstanding administrative practice of the FDIC, consistent with the requirements of the assessments regulations.

In its appeal to the Committee, the Bank reiterates its position that the Supervisory Group assignment lacked foundation. The Bank argues that it does not pose a substantial probability of loss to the DIF and that, absent such a probability, the classification is unwarranted. The Bank contends that the CAMELS composite rating of "4" appears to be DIR's sole justification for the classification, a justification the Bank claims is baseless, as the ROE nowhere describes the Bank as "posing a substantial probability of loss" to the DIF. In fact, the ROE characterizes the Bank's overall condition with such words as "risk" and "possibility," descriptors that, the Bank avers, are more consistent with the definition of Supervisory Group "B" ("institutions that demonstrate weaknesses which, if not corrected, could result in significant deterioration of the institution and increased risk of loss to the [DIF])." Moreover, the Bank denies the probability of loss, asserting that the deficiencies addressed by the FDIC in the ROE were in connection with a single, specific division (the *** Division) and therefore do not apply to the Bank's operations as a whole.

Finally, the Bank contends that the FDIC itself concedes that all "4"-rated institutions do not necessarily belong in Supervisory Group "C," pointing to the use of the word "generally" in the Supervisory Group Descriptions found in the assessment guidance in FIL 90-2003. The use of such a limiting term implies that, the Bank reasons, there are "exceptional" situations in which some "4"-rated institutions belong in Supervisory Group "B." These "exceptional" cases must include institutions, such as the Bank, that do not pose a "substantial probability of loss to the [DIF]."

ANALYSIS

For purposes of determining the annual assessment rate for insured depository institutions, each institution is assigned an assessment risk classification (Risk Categories I through IV). Arriving at one of these classification involves a two-step process governed by the FDIC's assessments regulations: (1) a capital evaluation in which an institution is assigned to one of three capital classifications (Well-Capitalized, Adequately Capitalized, and Undercapitalized) based on data reported in the institution's Report of Income and Condition (the "Call Report") for the quarterly assessment period; and (2) a supervisory evaluation (Supervisory Group "A," "B," or "C") for each quarterly assessment period, based on a variety of factors. *See* 12 C.F.R. § 327.9(b)(2) (capital evaluations) and 12 C.F.R. § 327.9(c) (supervisory evaluations).

The assignment of Risk Category completes the process. Risk Category II includes all institutions in Supervisory Group A that are Adequately Capitalized and all institutions in Supervisory Group B that are Well- or Adequately Capitalized. Risk Category III includes all Supervisory Group "A" and "B" institutions that are Undercapitalized and all Supervisory Group "C" institutions that are Well- or Adequately Capitalized. 12 C.F.R. § 327.9(a)(2) and (3).

For the first step, the capital evaluation, the Bank reported risk-based capital ratios on its September 30, 2008 Call Report that were at an "Adequately Capitalized" level, as defined by the FDIC's assessments regulations. 12 C.F.R. § 327.9(b)(2).

Section 327.9(c) of the FDIC's regulations governs the second step of this process, the supervisory evaluations:[1]

> (c) *Supervisory evaluations.* Each institution will be assigned to one of three Supervisory Groups based on the Corporation's consideration of supervisory evaluations provided by the institution's primary federal regulator. The supervisory evaluations ***include the results of examination findings by the primary federal regulator, as well as other information that the primary federal regulator determines to be relevant***. In addition, the Corporation will take into consideration ***such other information*** (such as state examination findings, if appropriate) ***as it determines to be relevant to the institution's financial condition and the risk posed*** to the Deposit Insurance Fund. The three Supervisory Groups are:
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> (1) *Supervisory Group "A."* This Supervisory Group consists of financially sound institutions with only a few minor weaknesses;
> (2) *Supervisory Group "B."* This Supervisory Group consists of institutions that demonstrate weaknesses which, if not corrected, could result in significant deterioration of the institution and increased risk of loss to the Deposit Insurance Fund; and
> (3) *Supervisory Group "C."* This Supervisory Group consists of institutions that pose a substantial probability of loss to the Deposit Insurance Fund unless effective corrective action is taken.

12 C.F.R. § 327.9(c) (emphasis supplied).

As a matter of longstanding practice and as described in Financial Institution Letter 90-2003 ("FIL 90-2003"), as well as on the assessments pages of the FDIC's website, institutions with a CAMELS rating of 1 or 2 are generally assigned to Supervisory Group "A"; those with a CAMELS rating of 3 to Supervisory Group "B"; and those with a CAMELS rating of 4 or 5 to Supervisory Group "C."

Changes to an insured institution's risk assignment resulting from a supervisory ratings change become effective as of the date of written notification to the institution by

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[1] The FDIC has provided these rules to the industry in FILs 103-2006 and 90-2003 and further guidance at http://www.fdic.gov/deposit/insurance/assessments/capital_groups.html.

the institution's primary federal regulator (here, the FDIC). 12 C.F.R. § 327.4(f)(1). The Bank received written notification of its supervisory rating on July 2, 2008. Accordingly, on that date, the Bank's Supervisory Group was downgraded to "C," and as an Adequately Capitalized Supervisory Group "C" institution, its risk assignment was downgraded from Risk Category II to Risk Category III.

The Uniform Financial Institutions Rating System ("UFIRS"), established by the Federal Financial Institutions Examination Council ("FFIEC"), describes institutions with a CAMELS composite rating of "4" in complete detail. The Committee finds that the Bank's reading of the CAMELS composite "4" rating is unreasonably narrow, and, in fact, the Bank truncates the definition that it cites. Although it is true that FFIEC describes a "4"-rated institution as "pos[ing] a risk to the deposit insurance fund," the definition says a great deal more about risk. The definition states, "[I]n most cases, [a] formal enforcement action is necessary to address the problems" and further warns that "[f]ailure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved." The CAMELS composite "4" definition cautions that financial institutions in this group are not capable of withstanding business fluctuations. All told, the definition serves as a warning that a "4"-institution poses a severe risk of loss to the DIF. The Bank's argument, in its concentration on a single phrase within the definition, does not take into account the totality of that definition. Consequently, the Committee rejects the Bank's narrow reading of the FFIEC composite "4" rating.

Central to the Bank's argument that it is not a Group "C" institution is that it does not pose a risk of substantial probability of loss to the DIF. The Bank argues that the use of "generally" implies that there are some "4"-rated institutions that must belong in Group "B"; that those exceptional cases are institutions that do not pose a substantial probability of loss to the DIF; and that as an institution that does not pose such a risk, it belongs in Group "B." However, the Committee finds that on the evidence in this record the Bank *does* pose a risk of substantial probability of loss. With the failure of their minor premise, the Bank's syllogism must itself fail.

The Committee notes that prior to January 1, 2007 when the implementing assessments regulations (Federal Deposit Insurance Reform Act of 2005) went into effect, the FDIC assessed risk for the coming period based on current data but continued to look at information for a six-week period (the *reconcilement period*) following the cut-off date to allow for consideration of unusual circumstances. Accordingly, "generally" was used largely to describe the potential exceptions to the Group assignments resulting from the *reconcilement period*. Under the Reform Act implementing regulations, the reconcilement period has been eliminated, and thus, instances of deviation of the Group assignments from the primary federal regulator's composite ratings seem less likely. Although the regulation does not foreclose the possibility of an exception, we find that, under these facts, the Bank clearly does not merit such treatment.

Finally, the Committee finds that the Bank's argument that its deficiencies were entirely related to a single division ignores the findings of the ROE. Contrary to the Bank's contention, the ROE makes clear that the risks and the effects of those risks were not solely limited to a specific division (the *** Division). In fact, even the transmittal letter accompanying the ROE advises of the dangerous waters which the Bank has entered as a result of the Indirect Auto Loan Division:

> The Board has failed to properly oversee the operations of the bank. Most of the bank's current problems can be directly attributed to the decision to enter into *** financing, without incorporating proper controls and safeguards to effectively monitor the portfolio's quality. Management's failure to institute effective credit administration, underwriting, and oversight policies has rendered asset quality deficient and in need of immediate remedial action. Likewise, the bank's earnings have fallen well below projections, due to high overhead, increased loan loss provision, and narrowing margins due to the use of high cost deposits, all of which are related to the establishment, quality, and funding of the *** portfolio.

While the ROE may not use the exact words found in the Supervisory Descriptions (posing the risk of a substantial probability of loss), it does point out that the "decision to originate *** loans has impacted many facets of the bank's operations, and has resulted in a decline in the bank's overall financial condition." Moreover, the ROE notes that management itself has failed to monitor risk by the division:

> The risk in the *** portfolio has not been quantified and compared to capital. The board has not received reports that provide adequate information to assess the level of asset risk within the *** portfolio and to consider the size and potential risks of this asset concentration.

The fact is that the Bank has not yet turned profitable, and earnings are insufficient to support operations and maintain appropriate capital levels. The ROE goes on to observe that "if management had not initiated the [*** Loan] Division, the bank would have been profitable by March 31, 2008." Loan loss reserves, capital levels, liquidity, sensitivity, and other areas of the Bank have all suffered as a direct result of the actions of the Division. The Committee finds that, consistent with the assessments regulations, DIR has taken careful note of the results of the examination as a whole and has rightly determined that the Bank, as a Supervisory Group "C" institution, poses a substantial probability of loss to the DIF unless effective corrective action is taken.

CONCLUSION

For the reasons set forth above the Bank's appeal is denied. The Committee finds that the Bank's supervisory evaluation is the result of a consistent application of the risk-based assessment rules and longstanding administrative practice and guidance.

By direction of the Assessment Appeals Committee, date June 15, 2009

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