Office of Inspector General

Office of Audits and Evaluations
Report No. AUD-15-007

Material Loss Review of Doral Bank, San Juan, Puerto Rico

September 2015

Office of Inspector General

Executive Summary

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Why We Did The Audit

The Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico closed Doral Bank (Doral), San Juan, Puerto Rico, on February 27, 2015, and named the FDIC receiver. On March 6, 2015, the FDIC notified the OIG that total assets at closing were $5.6 billion and that the loss to the Deposit Insurance Fund (DIF) was $748.9 million. As of July 31, 2015, the estimated loss had decreased to $698.4 million. As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review (MLR) of the failure of Doral.

The objectives of this MLR were to (1) determine the causes of Doral's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Doral, including the FDIC's implementation of the *Prompt Corrective Action* (PCA) provisions of section 38 of the FDI Act. The scope of our review covered examinations performed and supervisory actions taken from 2005 until Doral failed in 2015.

Background

Doral was originally established as a mutually owned federal savings bank in 1981. In September 1993, the bank was acquired and recapitalized by the Doral Financial Corporation (DFC), a financial holding company. In October 1997, the bank switched its charter from a federal savings bank to become a state non-member bank regulated by the FDIC. The conversion was part of DFC's strategy to increase the size and market share of Doral. Through its other subsidiaries, DFC also engaged in the origination, sale, and servicing of mortgage loans. At the time of the charter conversion, the bank had assets of $340 million and primarily originated and retained single-family mortgages. Doral's total assets increased significantly, peaking at $11.2 billion in December 2004. Although the bank continued to focus on residential mortgage lending, its commercial real estate loan portfolio grew during this period.

In April 2005, DFC announced the need to restate its financial statements for the years 2000 through 2004 due to irregularities in its mortgage business. Although the restatement had only a minor impact on Doral, DFC's financial condition was weakened considerably, and the FDIC no longer considered DFC a source of strength for Doral. A number of significant management changes took place at DFC and the bank in 2006 due, in part, to concerns related to the restatement. Also during 2006, DFC entered into a consolidated agreement with the Secretary of the Department of Treasury of Puerto Rico (also referred to as the Hacienda) to address the overpayment of income taxes during the restatement period. The result of this and prior agreements was the creation of a deferred tax asset on various DFC entities' financial statements. Notably, the 2006 agreement became the basis of a new agreement made between the DFC and the Hacienda in 2012. As discussed later, issues surrounding the regulatory treatment of the later agreement emerged as factors impacting Doral's capital position in the period 2012 to 2014. In 2007, to strengthen the holding company's financial position, DFC's new executive leadership led efforts to raise $610 million in capital, which resulted in the significant recapitalization of the holding company.

Like other insured depository institutions operating in Puerto Rico, Doral relied heavily on wholesale funding, and the business activities and credit exposure of both DFC and Doral were concentrated in Puerto Rico. Accordingly, significant to understanding the history of Doral is to understand economic conditions in Puerto Rico over the past decade.

Puerto Rico's current recession started in 2006, nearly 2 years before the U.S. downturn and has continued well past the official end of the U.S. recession. Further, the government is in the midst of a prolonged fiscal crisis. The economic conditions in Puerto Rico had a severe impact on Doral's loan portfolio.

Audit Results

Causes of Failure and Material Loss

Poor asset quality was the underlying cause of Doral's failure. Puerto Rico's severe and prolonged economic decline coupled with weak underwriting and risk management practices were significant factors in the deterioration of Doral's loan portfolio. Management's strategies for handling its troubled loan portfolio were based on overly optimistic assumptions in light of actual economic conditions and proved to be ineffective over time. In addition, Doral's flawed allowance for loan and lease losses methodology masked the extent of deterioration in its loan portfolio. Further, the Board's oversight of management was inadequate, given the bank's size, financial condition, and challenges.

Negative earnings resulting from losses associated with the loan portfolio progressively eroded capital. Doral's holding company served as a source of strength for a period of time, but the amount and quality of DFC's capital proved to be insufficient. In addition, in 2014, the FDIC determined that the $286 million in prepaid tax assets on Doral's books, much of which had been downstreamed by DFC to the bank, should not have been included in regulatory capital until collected by the bank from the Hacienda. As a result, the bank did not comply with capital requirements under an existing formal enforcement action with the FDIC. Further, Doral was no longer statutorily able to enhance liquidity by accepting, renewing, or rolling over any brokered deposits. Because Doral was not in a sound financial condition to continue operations, OCFI closed Doral and appointed the FDIC as receiver on February 27, 2015.

The FDIC's Supervision of Doral

Between 2005 and 2014, the FDIC and OCFI conducted joint safety and soundness examinations of Doral and the FDIC performed limited scope reviews in 2011 and 2014. As Doral's condition deteriorated, the FDIC and OCFI issued a number of progressively stronger supervisory actions. Following the 2011 examination, Division of Risk Management Supervision (RMS) officials placed Doral on a targeted examination schedule. Additionally, beginning in 2006, the FDIC's New York Regional Office recognized the need to closely monitor economic and banking conditions in Puerto Rico, leading to the development of an annual supervisory strategy. The analysis of economic data and annual risk profiles and trends informed institution-specific supervisory strategies, including one for Doral.

We have no concerns with the FDIC's overall level of supervisory attention given to Doral or the supervisory strategy. However, we had to consult with FDIC officials to determine whether the FDIC complied with FDI Act examination frequency requirements when Doral was placed on a targeted examination schedule, which provides for a more continuous onsite presence. Guidance related to RMS' large state nonmember onsite supervision program that describes continuous examination methodologies (i.e., visitations and limited scope reviews conducted throughout the year) does not address dates to be used for purposes of monitoring the FDI Act examination frequency requirements. The *Risk Management Manual of Examination Policies* explicitly states that because limited scope examinations or visitations are not full scope examinations, those do not satisfy the examination frequency requirements. Clarifying guidance on how using a targeted examination schedule impacts compliance with examination frequency requirements would help ensure consistency in this supervisory approach.

Generally, the FDIC's assessment of Doral's condition and assignment of component and composite ratings was consistent with supervisory guidance and reflected the increasing deterioration in the loan portfolio, deficient earnings, and the threat to capital. For example, asset quality and earnings were progressively downgraded beginning in 2007. Further, management ratings assigned in 2005 through 2009 appropriately reflected management's (1) lack of responsibility for the high-risk lending strategy undertaken before 2005 and economic conditions in Puerto Rico; (2) responsiveness to supervisory concerns at that time; and (3) ability to successfully raise capital.

That said, with the benefit of hindsight, downgrading the management component rating in 2009, further downgrading the management rating and the composite rating in 2010, and imposing stronger enforcement actions following both examinations may have been prudent. In these examinations, we believe greater skepticism of management's capability to develop and implement effective plans to address the significant deterioration in Doral's loan portfolio and deficient earnings may have been warranted. We recognize that doing so may not have changed the eventual outcome. However, given Doral's overall risk profile, such actions, particularly in 2010, would have been more consistent with the FDIC's forward-looking approach that was being emphasized at the time and the forward-looking supervision program adopted in 2011 that focuses on risks when assigning ratings. Additionally, such actions may have garnered needed Board attention at a critical time in Doral's history.

Further, the FDIC could have been more critical and proactive in its evaluation of the regulatory capital treatment of the Hacienda tax asset in 2012, when the FDIC first became aware of DFC's plans to downstream the asset to Doral to serve as regulatory capital. We determined Doral would likely have been *Undercapitalized* a few months earlier assuming that Doral would not have taken any different actions that impacted capital. More significantly perhaps, had the FDIC determined the asset was not eligible for regulatory capital in 2012, Doral may have accelerated its capital-raising efforts. FDIC officials did coordinate with Federal Reserve counterparts and OCFI on the matter, but RMS lacks a formal process for escalating complex and/or unique accounting topics internally to ensure such matters are vetted by the appropriate subject matter experts within the division. With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner.

Recommendations and Corporation Comments

This report includes two recommendations addressed to the Director, RMS. The first one is intended to enhance the effectiveness of supervisory controls for ensuring the FDIC's compliance with the FDI Act examination frequency requirements when a bank is on a targeted examination schedule. The second recommendation involves issuing or revising policy guidance to document the requirements and responsibilities of Regional Accountants related to conducting analysis for complex and/or unique accounting transactions, including when such matters should be escalated within the Division. The

Director, RMS, provided a written response, dated August 28, 2015, to a draft of this report. In the response, the Director reiterated the OIG's conclusions regarding the causes of Doral's failure and concurred with the two recommendations. RMS' planned actions are responsive to the recommendations and the recommendations are considered resolved.

Contents

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, Virginia 22226

Office of Audits and Evaluations
Office of Inspector General

DATE: September 3, 2015

MEMORANDUM TO: Doreen R. Eberley, Director
Division of Risk Management Supervision

/Signed/

FROM: E. Marshall Gentry
Assistant Inspector General for Evaluations

SUBJECT: *Material Loss Review of Doral Bank, San Juan, Puerto Rico* (Report No. AUD-15-007)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR)[1] of the failure of Doral Bank (Doral), San Juan, Puerto Rico. The Office of the Commissioner for Financial Institutions of Puerto Rico (OCFI) closed the institution on February 27, 2015, and appointed the FDIC receiver. On March 6, 2015, the FDIC notified the OIG that Doral's total assets at closing were $5.6 billion, and the estimated loss to the Deposit Insurance Fund (DIF) was $748.9 million. As of July 31, 2015, the estimated loss to the DIF had decreased to $698.4 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

The objectives of this MLR were to (1) determine the causes of Doral's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Doral, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. The scope of our review covered the period from the 2005 examination until Doral failed in 2015. This report contains two recommendations intended to enhance the effectiveness of the FDIC's supervisory controls.

The report contains several appendices. Appendix 1 contains details on our objectives, scope, and methodology; Appendix 2 contains a glossary of key terms; Appendix 3 contains a list of acronyms and abbreviations; Appendix 4 contains the Corporation's

[1] Certain terms that are underlined when first used in the report are defined in Appendix 2, *Glossary of Terms.*

comments on this report, and Appendix 5 contains a summary of the Corporation's corrective actions.

Background

History and Description of Doral

Doral was originally established as a mutually owned federal savings bank in 1981 as Catano Federal Savings and Loan Association of Puerto Rico. The bank underwent several name changes after being established and converted to stock ownership in 1990. In September 1993, the bank was acquired and recapitalized by the Doral Financial Corporation (DFC), a financial holding company, and the name of the bank was changed to Doral Federal Savings Bank.[2] In October 1997, the bank switched its charter from a federal savings bank to become a state non-member bank regulated by the FDIC. The conversion was part of DFC's strategy to increase the size and market share of Doral. Through its other subsidiaries, DFC also engaged in the origination, sale, and servicing of mortgage loans.

At the time of the charter conversion, the bank had assets of $340 million and primarily originated and retained single-family mortgages. Doral underwent a period of substantial growth through December 2004 with total assets peaking at $11.2 billion. Although still a mortgage lender, Doral began increasing its commercial real estate (CRE) lending during the growth period. In April 2005, DFC announced the need to restate its financial statements for the years 2000 through 2004 due to irregularities in its mortgage business. The restatement resulted in an aggregate reduction of $694 million in DFC's equity, causing DFC's financial condition to be considerably weaker. Additionally, DFC became subject to litigation and a Securities and Exchange Commission inquiry. The restatement had only a minor impact on Doral. However, the FDIC no longer considered DFC a source of strength for Doral.[3]

A number of significant management changes took place at DFC and the bank in 2006 due, in part, to concerns related to the restatement of DFC's financial statements. Also during 2006, DFC entered into a consolidated agreement with the Secretary of Department of Treasury of Puerto Rico (DOT and also referred to as the Hacienda) to address the overpayment of income taxes during the restatement period. The result of this and prior agreements was the creation of a deferred tax asset (DTA) on various DFC entities' financial statements. Notably, the 2006 agreement became the basis of a new agreement made in 2012 between DFC and the Hacienda. Issues surrounding the regulatory treatment of the later agreement emerged as factors impacting Doral's capital position in the period 2012 to 2014 and are discussed in detail later in this report.

[2] DFC had a relatively complex and interrelated organizational structure. Doral, a subsidiary of DFC, had five subsidiaries, of which only three were considered active at the time the bank was closed.
[3] A fundamental and long-standing principle underlying the Federal Reserve's supervision and regulation of a bank holding company is that bank holding companies should serve as sources of financial and management strength to their subsidiary banks.

In 2007, to strengthen the holding company's financial position, DFC's new executive leadership led efforts to raise $610 million in capital from a newly registered bank holding company funded by a group of institutional investors (Doral Holdings). The holding company restructured other subsidiary operations, including transferring its mortgage servicing and mortgage origination operations to Doral, its principal banking subsidiary. The transactions resulted in the significant recapitalization of the holding company.

In addition to branches in Puerto Rico, Doral operated in the U.S. through branches in New York and Florida. Like other insured depository institutions operating in Puerto Rico, Doral relied heavily on wholesale funding.[4] Reliance on wholesale funding generally increases an institution's liquidity risk profile because during periods of financial stress, this type of funding may become unavailable. Table 1 presents a snapshot of Doral's financial condition for the 10 years ending December 31, 2014.

Table 1: Selected Financial Data for Doral, 2005 to 2014

Financial Measure ($000s)	12/31/2014	12/31/2013	12/31/2012	12/31/2011	12/31/2010
Total Assets	$5,898,515	$7,970,729	$7,797,099	$7,241,449	$7,662,627
Total Loans	$4,652,078	$6,381,657	$6,231,270	$5,814,860	$5,341,856
Total Deposits	$4,097,734	$5,022,196	$4,667,578	$4,440,693	$4,465,896
Total Equity Capital	$427,219	$699,967	$654,253	$648,121	$651,764
FHLB Borrowings*	$378,673	$592,080	$259,382	$187,000	$423,420
Brokered Deposits	$703,891	$1,426,388	$1,996,235	$2,157,808	$2,349,163
Net Income (Loss)	$(336,269)	$(80,884)	$ (90,929)	$(11,930)	$(260,744)
Financial Measure	**12/31/2009**	**12/31/2008**	**12/31/2007**	**12/31/2006**	**12/31/2005**
Total Assets	$9,288,322	$9,048,489	$7,646,254	$9,220,610	$10,943,402
Total Loans	$5,246,926	$4,931,893	$4,585,593	$3,880,310	$3,332,174
Total Deposits	$4,612,303	$4,389,411	$4,289,715	$4,006,130	$3,876,582
Total Equity Capital	$603,028	$507,284	$544,135	$613,312	$574,849
FHLB Borrowings*	$780,500	$264,080	$315,000	$210,000	$117,000
Brokered Deposits	$2,632,318	$2,632,305	$2,473,628	$2,020,662	$1,886,923
Net Income (Loss)	$(36,172)	$(132,088)	$(196,852)	$19,492	$95,464

Source: Uniform Bank Performance Reports (UBPR) for Doral.
* FHLB Borrowings less than 1 year.

The business activities and credit exposure of both DFC and Doral, as its primary banking subsidiary, were concentrated in Puerto Rico. Consequently, despite the recapitalization, DFC repeatedly reported in its annual public filings that its financial condition was highly dependent on economic conditions in Puerto Rico. Accordingly, significant to understanding the history of Doral is to understand economic conditions in Puerto Rico over the past decade.

[4] U.S. tax policy, legislation enacted by the Puerto Rico government, and deposit alternatives are all contributing factors to the funding structure of Puerto Rico banks.

Economic Conditions in Puerto Rico

Puerto Rico's current recession started in 2006, nearly 2 years before the U.S. downturn and has continued well past the official end of the U.S. recession. Further, the government is in the midst of a prolonged fiscal crisis. Over the past decade:

- Puerto Rico's economy has contracted, reflecting in part, a weakening in the manufacturing sector and a declining ability to compete globally. A combination of factors has contributed to the long-term, structural decline in Puerto Rico's economy. These factors include a decline in U.S. and global demand for exports from the island, due to high energy costs; the expiration of 10-year corporate tax incentives in 2006; and high labor costs. Because manufacturing jobs tend to have higher salaries than many of the island's other sectors, the loss of these jobs has had a particularly adverse effect on Puerto Rico's economy.

- Unemployment levels are high relative to the U.S. According to data from the Bureau of Labor Statistics, Puerto Rico's unemployment rate was 12.4 percent in May 2015. By comparison, the U.S. unemployment rate was 5.5 percent as of May 2015.

- Large reductions in government payrolls have taken place as part of Puerto Rico's fiscal stabilization plan.

- Puerto Rico's population has declined by 7.3 percent, with half of the outflow occurring since 2011.

- The housing market on the island has been weak, with home prices declining.

After 5 years of contraction, and very slow growth in fiscal years (FY) 2012-2014, Puerto Rico's economy is projected to remain essentially flat in FY 2015.

Causes of Failure and Material Loss

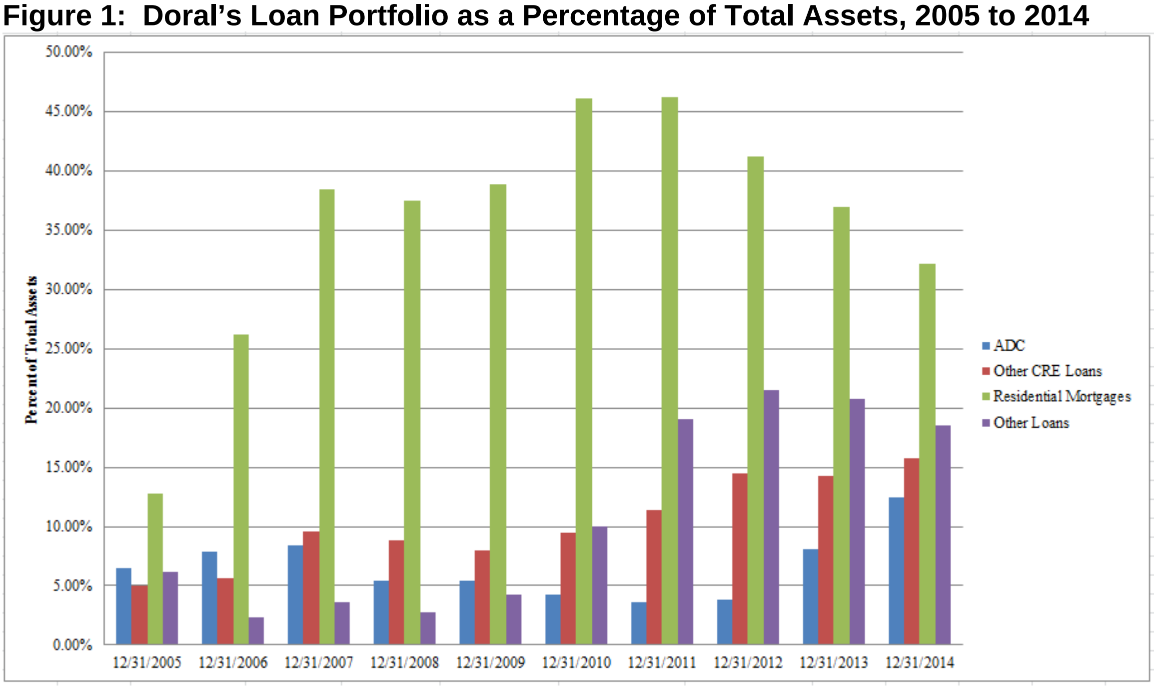
Poor asset quality was the underlying cause of Doral's failure. Puerto Rico's severe and prolonged economic decline coupled with weak underwriting and risk management practices were significant factors in the deterioration of Doral's loan portfolio. Management's strategies for handling its troubled loan portfolio were based on overly optimistic assumptions in light of actual economic conditions and proved ineffective over time. In addition, Doral's flawed allowance for loan and lease losses (ALLL) methodology masked the extent of deterioration in its loan portfolio. Further, the Board's oversight of management was inadequate given the bank's size, financial condition, and challenges.

Negative earnings resulting from losses associated with the loan portfolio progressively eroded capital. Doral's holding company served as a source of strength for a period of time, but the amount and quality of DFC's capital proved to be insufficient. In addition, in 2014, the FDIC determined that the $286 million of prepaid tax assets on Doral's books, much of which had been downstreamed by DFC to the bank, should not have been included in regulatory capital until collected by the bank from the Hacienda. As a result, the bank did not comply with capital requirements under an existing formal enforcement action with the FDIC. Further, Doral was no longer statutorily able to enhance liquidity by accepting, renewing, or rolling over any brokered deposits. Because Doral was not in a sound financial condition to continue operations, OCFI closed Doral and appointed the FDIC as receiver on February 27, 2015.

Deficient Loan Portfolio Derived, in Part, from Legacy High-Risk Lending

From 2005 to 2014, Doral's loan portfolio primarily consisted of CRE, including acquisition, development, and construction loans (ADC), and 1-4 residential loans (residential mortgages). According to the *Risk Management Manual of Examination Policies* (Examination Manual), the quality of a bank's loan portfolio is what largely determines the risk to depositors and to the DIF. Doral's loan portfolio in 2005 was almost entirely secured by real estate. The degree of risk in a real estate loan depends primarily on the loan amount in relation to collateral value; the interest rate; and, most importantly, the borrower's ability to repay in an orderly fashion. The Examination Manual further notes that economic downturns can adversely affect borrowers' repayment potential and can lessen a bank's collateral protection. Figure 1 presents the composition of Doral's loan portfolio over time relative to total assets.

Figure 1: Doral's Loan Portfolio as a Percentage of Total Assets, 2005 to 2014

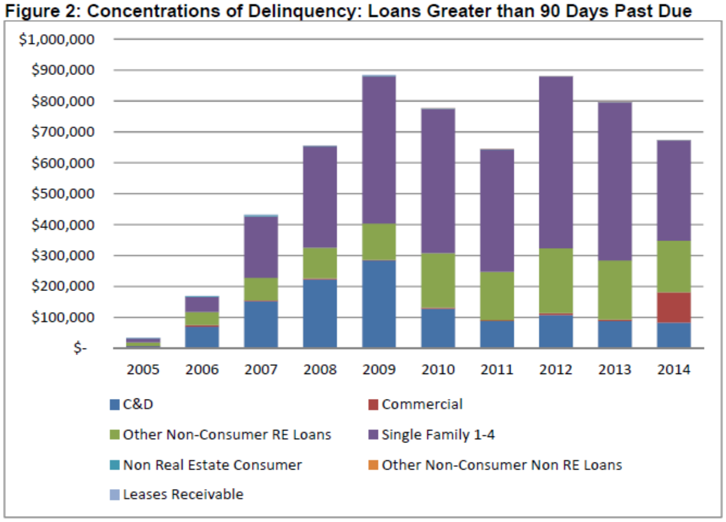


Source: UPBRs for Doral.

With respect to total loans, residential mortgages represented the bank's largest concentration of loans at 42 percent in 2005 and steadily increased reaching its highest concentration of approximately 69 percent of total loans in 2009. In addition, examination reports state that prior to 2006, the bank engaged in high-risk lending of CRE and commercial loans. Examiners reported that before 2005, the bank had grown at an accelerated pace and made lending decisions without full consideration of the associated risks.

Delinquent Loans. Figure 2 shows concentrations of past due loans from 2005 to 2014. Examiners identified deterioration in Doral's portfolio beginning in 2007 and attributed the decline to the economic downturn. More specifically, the 2007 examination report stated that the ADC loan portfolio had emerged as a significant risk. Examiners noted in 2009 that the residential mortgage loan portfolio (i.e., single family 1-4) had experienced the most deterioration since 2006, with CRE deterioration lagging only slightly. For example, as of December 31, 2009, residential loans represented 50 percent of the bank's total nonaccrual loans. As of December 31, 2014, $674 million of Doral's total loans, or 14.4 percent, were at least 90 days past due.

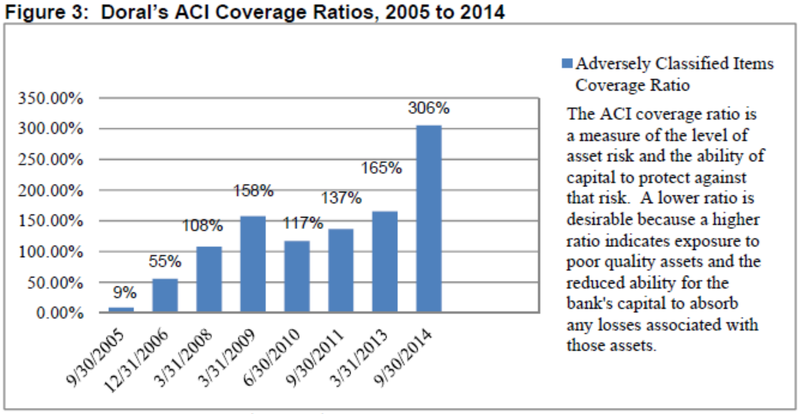
Figure 2: Concentrations of Delinquency: Loans Greater than 90 Days Past Due



Source: UPBRs for Doral.

Adversely Classified Assets and Charge-Offs. At the 2007 examination, classified ADC loans represented approximately 70 percent of total classified loans and 65 percent of loans classified as loss. Examiners noted that prior management had approved the majority of the adversely classified assets, in this case ADC loans, during 2004 and 2005. In 2009, examiners stated that management had been proactive in addressing the ADC portfolio. As a result, although ADC-related classifications were increasing, the trend was not as pronounced. However, by this time, the residential loan portfolio was beginning to deteriorate. As shown in Figure 3, Doral's Adversely Classified Items

Figure 3: Doral's ACI Coverage Ratios, 2005 to 2014

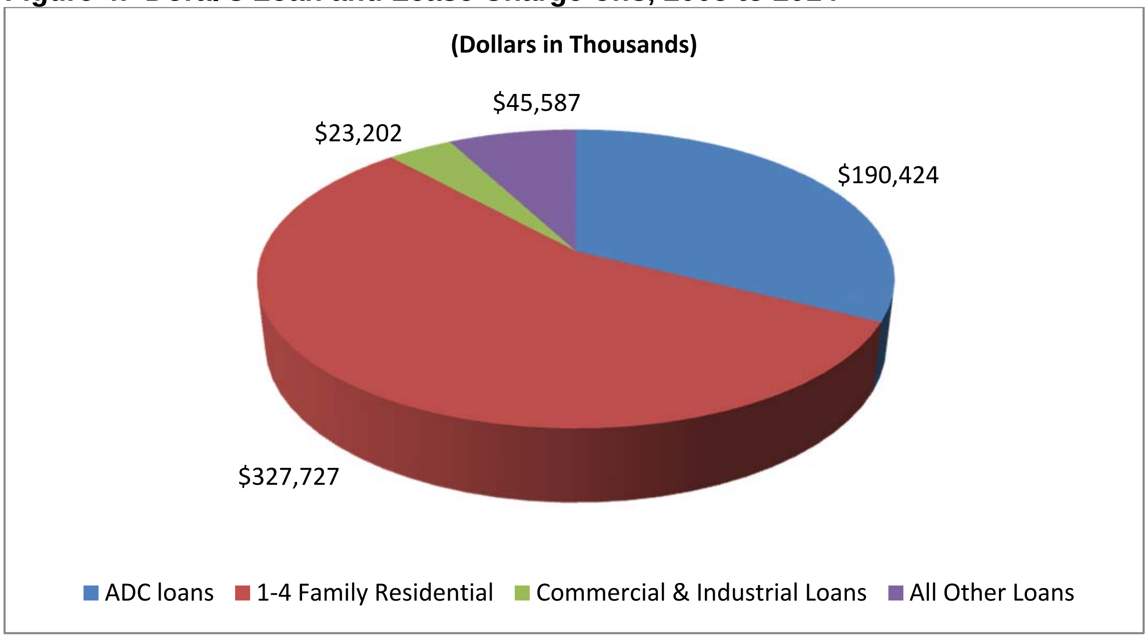


Source: OIG analysis of examination reports.

(ACI) Coverage Ratio remained high, above 100 percent from 2008 until 2013.[5] As discussed later, these ratios were likely understated due to Doral's poor risk management practices that masked the extent of its troubled loans.

The last examination report, issued shortly before the bank failed, stated that asset quality continued to be critically deficient, and significant charge-offs and asset sales between examinations had not resulted in any material improvement in loan portfolio quality. As shown in Figure 4, for the 10-year period ending December 31, 2014, most of Doral's loan charge-offs involved residential mortgages.

Figure 4: Doral's Loan and Lease Charge-offs, 2005 to 2014



Source: Consolidated Reports of Condition and Income (Call Reports) for Doral.

Part of Doral's strategy for addressing its Puerto Rico portfolio deterioration included growing its U.S. portfolio as part of management's overall asset substitution strategy (i.e., replacing loans originated in Puerto Rico with loans originated in other markets). According to the 2011 examination report, management planned to increase earnings and improve asset quality by increasing its commercial lending in its New York operations, primarily through the purchase of large collateralized loan obligations in the syndicated loan market. The bank further shrunk its balance sheet and reduced interest rate risk by unwinding certain repurchase agreements. Notwithstanding the favorable shift in asset quality metrics resulting from the increased U.S. portfolio, Doral's overall credit risk (i.e., risk that the borrower would default) increased bank-wide because of the volume of problem loans.

While poor economic conditions in Puerto Rico and the resulting reduction in certain borrowers' ability to repay their loans were factors impacting the deterioration of Doral's portfolio, weak credit administration was also an important factor. The Examination

[5] The spike to 306 percent at the 2014 examination was a result of declining capital levels.

Manual states that a high volume of overdue loans almost always indicates liberal credit standards, weak servicing practices, or both. The following sections of this report describe Doral's management of problem loans and ineffective risk management practices.

Ineffective Management of Problem Loans

Examiners initially judged Doral's new management team to have the experience and technical skills necessary to successfully navigate the changing bank environment. As previously stated in this report, examiners also viewed the new management team to be proactive in dealing with deterioration in the ADC lending portfolio. However, over time, Doral's management failed to adapt plans and strategies to address actual economic conditions and trends, and its accounting practices understated the losses within its troubled loan portfolio.

The Examination Manual states management must adapt to continuously changing economic conditions, both at the national and local level. This is not to suggest that lending policies should be in a constant state of flux, nor does it suggest that management should be able to forecast totally the results of economic changes. However, bankers should realistically evaluate lending policies and individual loans in light of changing conditions. Reliance on previously existing conditions as well as optimistic hopes for economic improvement can lead to serious loan portfolio deterioration, particularly when coupled with one or more of the aforementioned causes and sources of loan problems.

The following describes Doral's handling of its problem loan portfolio:

CRE/ADC Loans. When problems first emerged in the ADC portfolio, Doral and DFC management made a strategic decision to restrict ADC lending to experienced clients with proven track records and suspended new ADC lending at the end of 2007. In April 2009, Doral entered into a contract with a real estate consultant to provide advisory services relating to the ADC portfolio. The consultant provided analysis to facilitate decisions on property build-out, loan restructuring, and foreclosure. Despite management's efforts to use that analysis and reduce non-performing assets, asset quality continued to deteriorate over the next several years. Approximately 51 percent of the loss classifications during 2010 were centered in the ADC loan portfolio. In addition, there was a marked increase in loans designated as special mention assets due to a large credit extended for the purpose of financing the sale of approximately $102 million in ADC loans to an affiliate of Doral's real estate consultant.

Further, Doral was not properly accounting for troubled debt restructurings (TDRs). According to the *Policy Statement on Prudent Commercial Real Estate Restructured Loan Workouts*, institutions should consider loan workouts after analyzing a borrower's repayment capacity, evaluating the support provided by guarantors, and assessing the value of the collateral pledged on the debt. Doral modified CRE loans routinely without documenting any credit assessment of the borrower's financial condition or prospects for repayment under the revised terms. In addition, examiners reported that in many instances, prospects for repayment were dependent upon bank-funded interest reserve accounts (interest reserves). Doral's inappropriate loan modification practice overstated income and understated delinquency and loss amounts. Notwithstanding these efforts to mask the delinquency of loans, Doral's ACI increased from approximately 117 percent to 137 percent between September 30, 2010 and September 30, 2011.

Residential Loans. Doral implemented programs to assist delinquent residential mortgage borrowers in restructuring their loans. In response to an informal enforcement action put in place at the end of the 2009 examination, Doral developed a *Non-performing Asset Reduction Plan*. However, examiners noted in the 2010 examination that, among other things, the bank's plan assumed delinquency trends would improve and the local economy would stabilize. Both of these assumptions proved to be overly optimistic.

Doral started a residential mortgage modification program in September 2010, but its program was not based on the borrower's ability to perform over the term of the mortgage. For this reason and others, examiners criticized Doral's program for being inconsistent with the FDIC's *Loan Modification Guidelines* and the U.S. Government's *Home Affordable Modification Program*. Examiners reported that Doral's poorly implemented residential and commercial loan modification programs masked problem loans and were not documented in accordance with applicable rules and regulations. A majority of the modified residential loans were seriously delinquent at the time of restructure, and many were on nonaccrual status. Nonetheless, Doral immediately placed the loans on accrual status, as performing loans, at the time of the modification.

Call Report guidance for returning a restructured loan to accrual status requires that the asset be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. The evaluation must include consideration of the borrower's sustained historical repayment performance for a reasonable period before the date on which the loan is returned to accrual status.

Examiner testing during the 2011 examination revealed that the bank had not obtained individual borrower documentation or completed financial analysis to support the aggregate assumption that the borrower's troubled financial condition was temporary in nature or scope. In fact, examiners found that over 90 percent of the restructured borrower accounts sampled did not contain analysis or documentation for borrower repayment capacity at the full interest rate. Doral also extended additional credit to cover payments in arrears and for future payments. The examination revealed that the number of loans reported as performing was substantially overstated, causing the bank's past-due ratio to be understated. The 2013 examination also revealed that the bank had failed to complete prudent underwriting procedures, including performing inappropriate analysis of the borrower's ability to repay under new terms, extending credit under unreasonable terms and conditions, and failing to acquire updated appraisals to support secondary sources of repayment.

Poor Risk Management and Credit Administration Practices

Doral's inadequate risk management practices also served to mask the extent of deterioration in the bank's loan portfolio. Examination reports from 2005 to 2014 cited weaknesses related to critical risk management controls, including loan underwriting, appraisal practices, internal loan reviews, and the ALLL methodology. These weaknesses limited Doral's ability to effectively address its troubled loan portfolio.

Weak Underwriting Practices. Loan underwriting practices reduce the risk of loan loss by validating the borrower's capacity to repay and confirming the value of supporting collateral. Diligent underwriting is an essential element in a bank's ability to control inherent credit risk within its loan portfolio. Figure 5 highlights key factors that should be considered in originating a real estate loan.

Figure 5: Key Underwriting Considerations

- The capacity of the borrower, or income from the underlying property, to adequately service the debt.
- The value of the mortgaged property.
- The level of equity invested in the property.
- Loan-to-value limits by property type.
- Global cash flow analysis of the borrower.
- Maximum loan maturities by type of property.

Source: OIG review of *Interagency Guidelines for Real Estate Lending.*

In 2011, examiners noted underwriting exceptions in almost 50 percent of loans reviewed. Although examiners primarily attributed underwriting weaknesses to loans originated before 2006, examiners also reported underwriting weaknesses in loans originated after that period. Doral's weak underwriting practices made the bank more vulnerable to the effects of the economic downturn in Puerto Rico. The following examples illustrate some of examiners' underwriting concerns reported between 2005 and 2014:

- ADC projects focused on collateral protection, rather than cash flow from the project as the primary repayment source.
- Loan files were unorganized and often missing important documents, including original underwriting memoranda, appraisals, and income documentation.
- The borrower's ability to repay under the new loan terms was not analyzed.
- Extensions of credit were made with unreasonable terms and conditions.
- Updated appraisals were not acquired to support secondary sources of repayment.

In addition, bank employees involved in underwriting real estate loans would also review the appraisals and at times make changes to the valuations. *FDIC's Interagency Appraisal and Evaluation Guidelines* state that persons who review appraisals and evaluations should be independent of the transaction and have no direct or indirect interest, financial or otherwise, in the property or transaction, and be independent of and insulated from any influence by loan production staff.

Deficient Appraisal Practices. While borrowers' ability to repay their real estate loans according to reasonable terms remains the primary consideration in the lending decision, an institution also must consider the value of the underlying collateral. Prudent portfolio monitoring practices include having criteria for determining when to obtain a new appraisal or evaluation. Among other considerations, the criteria should address deterioration in the credit since origination or changes in market conditions. Examination reports cited management for being in contravention of the *Interagency Appraisal and Evaluation Guidelines* during five of the eight examinations conducted from 2005 to 2014. In addition, management was cited for apparent violation of FDIC Rules and Regulations Part 323, *Appraisals* during four of the eight examinations. As a result of these deficient appraisal practices, Doral did not address the risks in the declining real estate market by obtaining updated appraisals that are needed to properly value the portfolio. This oversight allowed management to extend additional credit without consideration of an accurate collateral value.

Inadequate Internal Loan Review. Internal loan reviews provide the basis for funding the ALLL and identifying problem assets in need of workout plans. Examiners reported weaknesses in Doral's internal loan review function in six of eight examination reports issued between 2005 and 2014. Deficiencies noted by examiners over this period included that Doral's loan review function: (1) was understaffed, (2) lacked independence, (3) did not track policy exceptions, (4) failed to identify impaired loans, (5) inaccurately and incompletely documented loan review results, (6) included an inadequate loan review scope, and (7) failed to identify significant underwriting and credit administration deficiencies. As such, Doral overstated the true condition of the loan portfolio and underfunded the ALLL due to the ongoing weaknesses in Doral's loan review program and improper classification of problem loans.

Inadequate ALLL Methodology. According to guidance related to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (*ALLL Policy Statement*), the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. The *ALLL Policy Statement* reiterates key concepts and requirements related to generally accepted accounting principles[6] and existing supervisory guidance. According to the guidance, an institution's process for determining the ALLL should be based on a comprehensive, well-documented, and consistently applied analysis of its loan portfolio that considers all significant factors that affect collectability. The analysis should include an assessment of changes in economic conditions and collateral values and their direct impact on credit quality. If declining credit quality trends are evident, the ALLL level as a percentage of the portfolio should generally increase.

[6] In 2009, the accounting standards were codified. Former Statement of Financial Accounting Standards (FAS) No. 5, *Accounting for Contingencies,* is now covered in Accounting Standard Codification (ASC) Subtopic 450-20, and former FAS No. 114, *Accounting by Creditors for Impairment of a Loan,* is now covered in ASC 310-10-35. These standards provide accounting guidance for loss contingencies on a pool basis and impairment of loans on an individual basis, respectively.

Despite the importance of having a strong ALLL methodology given the rapidly declining real estate values caused by the economic recession in Puerto Rico, examiners reported that the bank's methodology was consistently flawed. The ALLL methodology implemented by Doral was characterized by examiners as being another mechanism the bank employed to mask the extent of its troubled loan portfolio. As previously mentioned, deficient appraisal and loan review practices also contributed to the bank's underfunded ALLL. Specifically, Doral utilized older appraisals prepared when real estate conditions were more favorable in loan impairment calculations, which significantly overstated the value of underlying collateral. Loan officers discounted these older appraisals through the use of an internally prepared Customer Price Index (CPI); however, the CPI's methodology was flawed. The primary reason for Doral's ALLL shortfall was management's failure to obtain updated appraisals on a large number of classified ADC and CRE loans to properly account for loan impairment. The following highlights some examples of ALLL methodology weaknesses reported in examinations between 2005 and 2014:

- The ALLL methodology did not properly document impaired loan analysis.
- There was no independent review of the ALLL and loan review function to ensure that they were accurate and complete.
- The ADC loan review was not independent, classifications were not accurate, and there was no problem loan watch list.
- CRE loan review was satisfactory at loan inception, but there was no subsequent in-depth review for performing loans unless there were major changes.
- Controls in place to accurately estimate probable losses on impaired loans were ineffective.

In 2013, examiners concluded that management and the Board were either incapable of or unwilling to make needed changes to the ALLL program. As shown in Table 3, examiners required significant adjustments to the bank's ALLL, particularly from 2010 to 2014.

Table 2: ALLL Funding and Adjustments, 2005 to 2014

Examination as of Date	Doral's Calculation of ALLL	Increase Required by Examiners	Percentage Increase
September 30, 2005	$15,224,000	$6,231,000	41
December 31, 2006	$62,320,000	$0	n/a
March 31, 2008	$109,633,000	$0	n/a
March 31, 2009	$139,378,000	$0	n/a
June 30, 2010	$122,433,000	$38,290,000	31
September 30, 2011	$107,427,000	$53,000,000	49
March 31, 2013	$114,690,000	$31,000,000	27
September 30, 2014	$118,521,000	$53,441,000	45

Source: Doral's Reports of Examination 2005 to 2014.

Inadequate Board Oversight

The Examination Manual states that the quality of an institution's management, including its Board and executive officers, is perhaps the single most important element in the successful operation of an institution. According to the Examination Manual, the Board has overall responsibility and authority for formulating sound policies and objectives for the institution and for effectively supervising the institution's affairs. Examiners consistently concluded that the Board's involvement in Doral's activities was inadequate, especially considering the poor condition of the bank. Poor Board oversight allowed Doral's weak risk management practices to go unchecked and contributed to the deficient asset quality issues that plagued the bank. As the condition of the bank deteriorated, the composition of the Board changed dramatically due to resignations, so examiners viewed sufficient oversight as becoming increasingly unlikely.

The following provides some examples of Board deficiencies cited in examination reports, with increasing concern noted from 2010 to 2014:

- Board minutes did not sufficiently detail Board involvement in bank affairs.

- The Board failed to establish adequate policies, including policies for the lending function, ALLL, appraisals, and Other Real Estate Owned (OREO). In fact, examiners noted in 2011 that a number of policies and practices did not conform to Appendix A of Part 364 of the FDIC's Rules and Regulations, *Interagency Guidelines Establishing Standards for Safety and Soundness*.

- The Board failed to ensure that policies were being properly implemented. For instance, the 2013 examination stated that Doral lacked proper Board oversight to ensure management fully resolved the repetitive weaknesses identified by regulators and auditors.

- The Board failed to properly review and approve the relationship of the CRE consultant engaged by the bank and responsible for managing and servicing Doral's commercial and CRE/ADC loans. The Board had a responsibility to ensure that the bank's best interests were being served and potential conflicts of interest were properly controlled by bank management.

- The Board allowed excessive compensation for itself and the Chief Executive Officer (CEO). FDIC's Rules and Regulations, *Interagency Guidelines Establishing Standards for Safety and Soundness*, Appendix A, Part III, states that compensation shall be considered excessive when amounts paid are unreasonable or disproportionate to the services performed. The 2013 examination noted that from 2009 to 2011, Doral's shareholder return declined 87 percent while the CEO's compensation increased 30 percent, without any clear tie to overall bank performance. Based upon information in the 2013 Proxy Statement, of three peer group (peer) institutions, Doral's total compensation for its CEO was over 75 percent more than the next highest paid CEO. Additionally, compensation for all five Board members was 63 percent higher than the three peer institutions mentioned above.

Board member fees were paid entirely in cash, while all peer banks paid approximately 60 percent of fees in bank equity investments. Considering the continued extremely poor financial condition of the institution, including poor earnings performance, and the inability to adequately address prior examination criticisms, examiners found the levels of compensation for the CEO and directors to be excessive, significantly higher than peer banks, and not tied to overall bank performance.

- The Board allowed compensation agreements that provided for improper incentives. For example, the Chief Financial Officer's compensation package was based partially on the reduction of nonaccrual assets. Examiners noted in the 2013 examination report that this type of compensation appeared to be in direct contravention to the *Statement of Policy on Sound Incentive Compensation Policies*. That policy states, in part, compensation for risk management and control personnel should be sufficient to attract and retain appropriately qualified personnel and such compensation should not be based substantially on the financial performance of the business unit that they review. Rather, their performance should be based primarily on the achievement of the objectives of their functions, such as adherence to internal controls.

Dominant Official. The Board relied upon and was influenced by Doral's President/CEO, whom examiners first characterized as a dominant official in the 2011 examination. An independent consulting firm hired by Doral similarly concluded in a 2012 report that policy decisions continued to be dominated by the CEO, with little to no supervision by the Board. According to the Examination Manual, dominant officials or policymakers have been identified as a key risk factor in near failures and failures for many years due to their singular strategy, policy, membership selection, and other decision-making processes.

In 2013, examiners again concluded that Doral's management was dominated by the CEO's policies and corporate culture and the examination report included examples of short-sighted decisions made by the CEO that contributed to Doral's problems, such as:

- Significantly reducing compliance and risk management area staffing, which were areas contributing to many of the bank's weaknesses.

- Opening a facility in Miami, Florida, that spread out management and caused concerns with the effectiveness of supervision of Puerto Rico risk management activities.

- Terminating senior officers repeatedly, which examiners noted caused undue turmoil in the organization.

- Providing virtually no daily supervision of senior management officials' activities and daily operational decisions.

- Permitting a corporate culture that inhibited or discouraged effective risk management and internal identification of issues and concerns.

Negative Earnings and Capital Erosion

In 2014, the culmination of loan losses, revised asset valuations, and other capital related issues caused the bank to become *Undercapitalized* under provisions of section 38, PCA. The Examination Manual states that from a bank regulator's standpoint, the essential purpose of bank earnings, both current and accumulated, is to absorb losses and augment capital. Earnings are the initial safeguard against the risks of engaging in the banking business and represent the first line of defense against capital depletion resulting from weak asset quality.

Doral failed to generate a profit in the last 8 years of its existence. While examiners considered the bank's asset quality problems and provisions to be the primary driver of crippling losses, the 2013 examination report stated that core earnings showed minimal improvement from the previous examination and overhead expenses continued to be excessive. Further, the 2014 examination report explained that overhead expenses associated with consultants and vendors were a constant drain on the bank's earnings. Additionally, in 2014, the bank completed bulk asset sales that resulted in net losses. Examiners also reported that Doral's earnings were dramatically below those of other Puerto Rico banks. As of September 30, 2014, Doral reported a return on assets (ROA) of negative 4.77 percent. In contrast, the other five FDIC-insured institutions in Puerto Rico reported ROA's ranging from .63 to 1.11 percent.

Despite the period of negative earnings, the bank maintained risk-based capital ratios in excess of its peer group from 2005 through 2010. DFC provided net capital contributions totaling approximately $554 million from 2007 to 2010. However, Doral suffered operating losses of approximately $626 million during this same period. Table 3 provides a summary of the net capital contributions received by Doral, and the nature of those contributions, from 2007 to 2010. Contributions related to the Hacienda agreements are discussed separately below.

Table 3: Net Capital Contributions from DFC to Doral, 2007 to 2010

Year	Amount	Nature of Contribution
2007	$57.4 million	The Doral Mortgage subsidiary and related mortgage servicing rights valued at $212.4 million less a $155 million dividend paid to DFC.
2008	$182.9 million	$116.8 million of loans, $57.4 million forgiveness of intercompany receivables, and $8.7 million of collateralized mortgage obligations.
2009	$119.8 million	$79.8 million of loans and $40 million cash.
2010	$193.9 million	$167.5 million cash from third parties and $26.4 million of loans.
Total	$554.0 million	

Source: OIG review of Doral Board minutes and RMS examination work papers and reports.

Doral's declining capital levels and troubled financial condition also negatively impacted Doral's liquidity position. In March 2013, Doral's net-noncore funding dependence ratio of 54.90 percent remained significantly higher than the average of 34.40 percent for

Puerto Rico banks. Generally, the lower the ratio, the less risk exposure there is for a bank, whereas higher ratios reflect reliance on funding sources that may not be available in times of financial stress or adverse changes in the market. At that time, brokered deposits remained Doral's principal funding vehicle. The FDIC's Rules and Regulations Part 337, *Unsafe and Unsound Banking Practices*, states that any *Well Capitalized* insured depository institution may solicit and accept, renew, or roll over any brokered deposits without restrictions. However, after August 2012, Doral was considered to be *Adequately Capitalized* for PCA purposes because it was subject to a Consent Order (CO) with a capital provision and, accordingly, not permitted to accept, renew, or roll over any brokered deposits unless waivers were granted from the FDIC. Brokered deposits accounted for approximately 17 percent of Doral's total deposits as of December 31, 2014.

With available capital support nearly exhausted, DFC generated additional capital that it contributed to Doral in 2012 and 2013 by negotiating an agreement with the Hacienda to change the accounting treatment of its restatement-related DTA. In brief, the 2012 agreement, which was signed March 26, 2012, was designed to convert the DTA to a prepaid tax asset (interchangeably referred to as the Hacienda asset). The DTA was dependent on future earnings; however, the 2012 agreement stated that the overpayment of tax would be treated as a pre-payment that could be used to offset income taxes due either through reductions of estimated income taxes or through refunds over a period of 5 years, upon proper claim. DFC obtained concurrence from its external auditing firm to reflect the tax asset as a prepaid tax rather than a DTA in its financial statements. On March 27, 2012, DFC notified the FDIC about the agreement and its plans to include the prepaid taxes in its Tier 1 capital. Further, DFC publicly announced that it had reached agreement with the Hacienda on April 4, 2012, indicating that the agreement would result in an increase its Tier 1 capital. Although DFC was not required to seek regulatory approval, DFC's announcement was made before the FDIC had completed its review of the agreement. In addition, DFC had yet another prepaid tax asset related to prior tax years that DFC wanted to downstream to Doral. In order to do so, DFC entered into another agreement with the Hacienda in December 2013 that allowed DFC to contribute an additional $33 million of prepaid taxes (unrelated to the DTA) to Doral.

In the 2013 examination, examiners identified the following issues, resulting in the overstatement of capital and capital ratios reported on Doral's Call Reports:

- Certain residential mortgage loans contributed by DFC in 2009 and 2010 were initially recorded at book value rather than fair value, overstating capital until the loans were reserved as part of the ALLL process.

- Impaired residential mortgage loans were improperly risk weighted at 50 percent rather than 100 percent in the bank's risk-based capital calculations, overstating both the Tier 1 Risk-Based Capital Ratio and the Total Risk-Based Capital Ratio.

- The prepaid tax assets contributed by the holding company, as well as prepaid tax assets on the books of the bank, totaling $286 million in the aggregate, should not have been included in capital until collected by the bank from the Hacienda.

Once the prepaid tax adjustment was made to Doral's March 31, 2014, Call Report, the bank became *Undercapitalized*. The bank's capital continued to erode and the bank was closed on February 27, 2015.

The FDIC's Supervision of Doral

Between 2005 and 2014, the FDIC and OCFI conducted joint safety and soundness examinations of Doral and the FDIC performed limited-scope reviews in 2011 and 2014. As Doral's condition deteriorated, the FDIC and OCFI issued a number of progressively stronger supervisory actions. Following the 2011 examination, Division of Risk Management Supervision (RMS) officials placed Doral on a targeted examination schedule. Additionally, beginning in 2006, the FDIC's New York Regional Office (NYRO) recognized the need to closely monitor economic and banking conditions in Puerto Rico, leading to the development of an annual supervisory strategy. The analysis of economic data and annual risk profiles and trends informed institution-specific supervisory strategies, including one for Doral.

We have no concerns with the FDIC's overall level of supervisory attention given to Doral or the supervisory strategy. However, we had to consult with FDIC officials to determine whether the FDIC complied with FDI Act examination frequency requirements when Doral was placed on a targeted examination schedule (also referred to as continuous examination program), which provides for a more continuous onsite presence. Guidance related to RMS' large state nonmember onsite supervision program that describes continuous examination methodologies (i.e., visitations and limited scope reviews conducted throughout the year) does not address dates to be used for purposes of monitoring the FDI Act examination frequency requirements. The Examination Manual explicitly states that because limited scope examinations or visitations are not full-scope examinations, those reviews do not satisfy examination frequency guidance. Clarifying guidance on how using a targeted examination schedule impacts compliance with examination frequency requirements would help ensure consistency in this supervisory approach.

Generally, the FDIC's assessment of Doral's condition and assignment of component and composite ratings was consistent with supervisory guidance and reflected the increasing deterioration in the loan portfolio, deficient earnings, and the threat to capital. For example, asset quality and earnings were progressively downgraded beginning in 2007. Further, management ratings assigned in 2005 through 2009 reflected management's (1) lack of responsibility for the high-risk lending strategy undertaken before 2005 and economic conditions in Puerto Rico; (2) responsiveness to supervisory concerns at that time; and (3) ability to successfully raise capital.

That said, with the benefit of hindsight, downgrading the management component rating in 2009, further downgrading the management rating and the composite rating in 2010, and imposing stronger enforcement actions following both examinations may have been prudent. In these examinations, we believe greater skepticism of management's capability to develop and implement effective plans to address the significant deterioration in Doral's loan portfolio and deficient earnings may have been warranted. We recognize that doing so may not have changed the eventual outcome. However, given Doral's overall risk profile, such actions, particularly in 2010, would have been more consistent with the FDIC's forward-looking approach that was being emphasized at the time and the forward-looking supervision program formally adopted in 2011 that focuses on risks when assigning ratings. Additionally, such actions may have garnered needed Board attention at a critical time in Doral's history.

Further, the FDIC could have been more critical and proactive in its evaluation of the regulatory capital treatment of the Hacienda tax asset in 2012, when the FDIC first became aware of DFC's plans to downstream the asset to Doral to serve as regulatory capital. We determined Doral would likely have been *Undercapitalized* a few months earlier, assuming that Doral would not have taken any different actions that impacted capital. More significantly perhaps, had the FDIC determined the asset was not eligible for regulatory capital in 2012, Doral may have accelerated its capital-raising efforts. FDIC officials did coordinate with Federal Reserve counterparts and OCFI on the matter, but RMS lacks a formal process for escalating complex and/or unique accounting topics internally to ensure such matters are vetted by the appropriate subject matter experts within the Division. Accordingly, we are recommending that enhanced procedures be developed. With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner.

Supervisory History

In addition to the eight full-scope joint examinations conducted by the FDIC and OCFI, the FDIC completed a targeted asset quality review (TAQR) on July 22, 2011, and the FDIC and OCFI completed a joint visitation on July 30, 2014.[7] Doral was also subject to the FDIC's offsite review program, the results of which did not alter the FDIC's supervisory strategy.

In March 2006, NYRO officials began to identify Puerto Rico as a unique risk area in quarterly risk assessments, amid emerging concerns associated with economic and banking conditions on the island. In June 2007, the NYRO decided to develop a separate comprehensive supervisory strategy for Puerto Rico for the 2008 examination cycle based on concerns that economic conditions in Puerto Rico would lead to additional asset quality problems in the future. The NYRO has prepared annual supervisory strategies for Puerto Rico in each of the subsequent years.[8] Doral's risk profile was elevated with

[7] The terms limited-scope examination and visitation are interchangeable and may be defined as any review that does not meet the minimum requirements of a full-scope examination.
[8] Because of the failure of three Puerto Rico institutions in 2010, an inter-division white paper substituted for the annual strategy in 2010 and a paper recapping FDIC resolution activity for those institutions served to guide supervision in 2011.

increasing risk trend from 2008 to 2012 and rated high between 2013 and 2015. Table 4 summarizes Doral's examination history, including resulting supervisory ratings and the supervisory actions taken from 2005 to 2014. Doral was also subject to additional supervisory actions related to consumer compliance and Bank Secrecy Act (BSA) issues in 2007 and 2008.

Table 4: Examination History of Doral, 2005 to 2014

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Supervisory Action
12/29/2005	9/30/2005	FDIC/OCFI	223223/2	CO to address issues related to restatement issue. Doral stipulated on 3/16/2006.
3/26/2007	12/31/2006	FDIC/OCFI	233323/3	CO still in effect. Bank Board Resolution (BBR) adopted 2/6/2008 to address 2007 examination.
5/19/2008	3/31/2008	FDIC/OCFI	232422/3	Earlier BBR addressed and new BBR adopted on 11/17/2008 to address 2008 examination.
6/29/2009	3/31/2009	FDIC/OCFI	242423/3	2008 BBR addressed and new BBR adopted 7/29/2010 to address 2009 findings.
8/9/2010	6/30/2010	FDIC/OCFI	343433/3	Memorandum of Understanding (MOU) became effective 8/26/2011.
10/3/2011	9/30/2011	FDIC/OCFI	444443/4	CO to address examination results. Doral stipulated 8/8/2012.
7/8/2013	3/31/2013	FDIC/OCFI	555554/5	CO still in effect
9/2/2014	9/30/2014	FDIC/OCFI	555555/5	OCFI closed the bank

Source: Examination reports and enforcement actions for Doral.

Examination Frequency. We reviewed Doral's examination history, in part, to assess the FDIC's compliance with FDI Act examination frequency requirements. Part 337.12 of the FDIC Rules and Regulations implements Section 10(d) of the FDI Act and governs the frequency of examinations for insured state nonmember banks. Part 337.12 requires a full-scope, on-site examination of every insured state nonmember bank at least once during each 12-month period. The Examination Manual states that the length of time between the end of one examination and the start of the next should not exceed 12 months.[9] The manual also provides that because limited scope examinations or

[9] The Manual states that for purposes of monitoring compliance with examination frequency schedules, the end of the examination is defined as the earlier of the date the examiner-in-charge submits the report for review, or 60 calendar days from the examination start date as defined in the examination report.

visitations are not full-scope examinations, those reviews do not satisfy the examination frequency requirements.

Although we found the timing of the joint FDIC and OCFI examinations of Doral to generally be in accordance with FDIC examination policies, we questioned whether the July 2013 examination was in compliance with the examination frequency requirement applicable to Doral. Based on our calculation, FDIC/OCFI started the 2013 examination 7 months late. However, RMS officials explained that using the July 8, 2013, start date from the 2013 examination report was incorrect because Doral had been placed on a targeted examination schedule following the 2011 examination. FDIC officials explained that by placing Doral on this schedule, examiners were onsite beginning in November 26, 2012. The results of the targeted reviews conducted, including reviews of Doral's NY portfolio, sensitivity to market risk, and securities portfolio, and Certified Public Accountant working papers, were rolled into the July 2013 examination report. Table 5 illustrates this effect on the 2013 examination frequency calculations using the different dates.

Table 5: OIG Analysis of Examination Cycle

Examination Dates	Applying Dates Defined in the Examination Manual Criteria	Applying Dates Based on Continuous Examination Cycle Explanation
End-date for 2011 examination	December 2, 2011*	December 2, 2011
Start date for 2013	July 8, 2013	November 26, 2012
Projected start date to be in compliance with FDI Act	December 3, 2012	
Elapsed time between examinations	19 months	11 months

Source: OIG Analysis of examination reports and targeted reviews.

*In accordance with the Examination Manual instructions, we added 60 days to the 2011 examination start date of October 3, 2011 to compute the 2011 examination end date of December 2, 2011. We then added 12 months to determine that the next annual examination start date should have been no later than December 3, 2012.

The NYRO's 2013 Puerto Rico Supervisory Strategy makes reference to the continuous examination program. However, officials acknowledged that there was no written guidance surrounding this program except for guidance for the supervision and monitoring of large banks within RMS. That guidance makes reference to point-in-time and continuous examination methodologies in the context of developing annual supervisory strategies. However, it does not describe criteria for employing either methodology or dates to be used for purposes of monitoring compliance with examination frequency requirements. Moreover, it does not address the Examination Manual's explicit statement that targeted or limited-scope reviews do not satisfy the requirements of Section 10(d) of the FDI Act. In our view, the lack of guidance surrounding compliance with examination frequency requirements when institutions are placed on a targeted examination schedule leaves the FDIC vulnerable to criticism about its compliance with the FDI Act. Clarifying guidance for using a targeted examination schedule would help ensure consistent use of the continuous monitoring program and facilitate monitoring compliance with FDI Act examination frequency schedule requirements. Accordingly, we recommend the Director, RMS:

Recommendation 1. Update guidance for placing an institution on a targeted examination schedule to define dates to be used for purposes of complying with FDI Act examination frequency requirements.

Supervisory Response to Key Risks

Examiners began downgrading Doral's component and composite ratings in 2005 because of issues related to DFC's accounting and challenges confronting the new management team. Examiners progressively downgraded component and composite ratings as the condition of the bank deteriorated between 2007 and 2014 because of losses associated with Doral's loan portfolio and management's struggles to appropriately address problems. By the 2013 examination, examiners determined the overall condition of Doral was critically deficient and the continued viability of the institution was in jeopardy. With the exception of Sensitivity to Market Risk, examiners downgraded all other components and the composite rating to a "5." The following section summarizes our assessment of examination ratings and supervisory actions for three key areas—asset quality, management, and capital—with a particular focus on examination results and supervisory actions taken between 2007 and 2013. Examiners' assessments of earnings and liquidity are included in our discussion of capital. Where applicable, we provide our views on lessons learned and are making a recommendation to establish a formal process for escalating complex accounting topics within RMS to ensure such matters are vetted by the appropriate subject matter experts within the division.

Examination Results

Asset Quality. As shown in the adjacent text box, except for 2005, when asset quality was viewed as satisfactory, examiners progressively downgraded Doral's asset quality rating to reflect the deterioration in Doral's loan portfolio. In 2005, examiners viewed the high concentration of real estate assets positively, noting the risk of loss from past-due or nonaccrual loans was "minimal." However, examiners noted the bank's lending policies were no longer satisfactory for the size and complexity of the bank. By 2007, Doral began experiencing earnings pressure resulting largely from weak loan performance after the economic recession began in 2006. The rating in both 2007 and 2008 was consistent with identified concerns within Doral's ADC loan portfolio and credit administration practices; significant increases in adversely

Doral's Asset Quality Ratings, 2005 to 2014

Examination	Examiner's Rating of Asset Quality and/or Credit Administration Practices	
2005	2	Satisfactory.
2007-2008	3	Less than satisfactory.
2009-2011	4	Deficient. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.
2013-2014	5	Critically Deficient.

Source: Doral reports of examination and Examination Manual.

classified assets; and Doral's general risk exposure relative to the economic trends emerging in Puerto Rico.

The 2009 examination reported a significant deterioration in Doral's residential portfolio, which examiners attributed to the overall increase in mortgage delinquencies throughout Puerto Rico. In 2010, examiners continued to be critical of asset quality and also began to criticize Doral's appraisal program. Doral management disagreed with the examination rating. The FDIC conducted a TAQR in 2011 due to the extent of asset quality deterioration observed during the 2010 examination. The TAQR identified numerous credit administration issues, such as improper reporting of nonperforming, nonaccrual, and TDR loans; poor appraisal ordering and review processes; lack of current appraisals supporting collateral valuations; deficient credit underwriting and loan administration procedures and policies; weak loan reviews and risk grading systems; and an inadequate ALLL.

The 2011 examination report was critical of Doral's residential loan restructuring program implemented in September 2010. The 2011 examination also criticized Doral's flawed ALLL methodology and noted the use of interest reserves without prudent underwriting and loan portfolio risk management practices. Further, examiners reported that management failed to charge off or collect all assets classified as loss in the 2010 examination report, or revise OREO policies, appraisal practices, and the ALLL methodology. Examiners noted the lack of good risk management practices heightened Doral's risk profile and exacerbated loan losses, especially during the economic stress of Puerto Rico's recession.

Doral's asset quality continued to deteriorate from this point forward through 2014 despite the fact that Doral was subject to increasingly more formal enforcement actions and close supervisory attention. FDIC officials speculated that management adopted a strategy of masking losses in "hopes" that the economy would recover and real estate values would rebound.

Management and the Board. The "3" rating assigned to the management component in 2005 represented a downgrade from the previous examination. The examination report stated that the downgrade reflected the need for enhanced Board supervision in light of challenges facing the new management team, including the lack of a strategic plan, issues with the bank's management information

Doral's Management Ratings, 2005 to 2014

Examination	Examiners' Assessment of Management and the Board	
2005-2007	3	Needs improvement or risk management practices 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. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.
2008-2009	2	Satisfactory. Minor weaknesses may exist, but are not material to safety and soundness and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.
2010	3	See description above.
2011	4	Deficient. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and requires immediate action..
2013-2014	5	Critically deficient. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Continued viability threatened. Replacing or strengthening management or the board of directors necessary.

Source: Doral reports of examination and Examination Manual.

systems, inadequate written policies, and risk management practices that had not kept pace with Doral's rapid growth prior to 2005.

As shown in the text box on the prior page, the management component rating remained a "3" in the 2007 examination, reflecting examiners' continued concern with leadership and management changes taking place in the bank. Examiners acknowledged the significance of management's successful recapitalization effort but reported concern with the Board's lack of oversight and management's failure to address a number of weaknesses, including staffing-related concerns.

In 2008, examiners upgraded the management component to reflect management's initiatives in monitoring and controlling risks, particularly in the loan area. Further, examiners noted that management had made a concerted effort to be more responsive to supervisory concerns. For example, the examination report stated that the bank had substantially upgraded its risk management processes and fully staffed risk management operations.

Although examiners found asset quality and earnings to be less than satisfactory in 2009, the management rating remained a "2." The 2009 examination noted continued and significant changes in Doral's management, with the CEO also assuming the title of President, new additions to the Board, and a new Executive Vice President for Finance and Investments. Examiners reported that management focused on improving asset quality by reducing the level of non-performing loans, tightening underwriting standards, improving management information systems, revamping the loss mitigation strategy, and improving controls over the foreclosure process. Management also decided to discontinue CRE lending. Further, management was responsive to recommendations from examiners related to the bank's loan review process and global cash flow analysis. However, examiners noted management's forecasts for improvements in earnings and non-performing loan levels were somewhat optimistic.

By the 2010 examination, examiners' assessment of management was beginning to change, and the management component rating was downgraded to a "3." The FDIC and OCFI contemplated assigning a "4" management rating but ultimately decided that additional work was needed to support a further downgrade. The examination report noted management performance was impacted by the departure of two senior officers. The rating downgrade to a "3" reflected, among other things, the institution's poor financial condition, systemic deficiencies identified within its appraisal program, and a number of apparent violations. Examiners were particularly concerned with Doral's underfunded ALLL. Examiners attributed the ALLL shortfall to management's failure to obtain appraisals on a large number of classified ADC and CRE loans and to properly account for loan impairment. Doral did not agree with the management rating. In fact, the CEO argued that the poor performance in 2010 was planned and caused by management's efforts to reduce risk. As discussed further below, the FDIC and OCFI issued an MOU following the examination.

In 2011, examiners downgraded the management rating to a "4." FDIC officials advised us that at that time they were becoming increasingly concerned with Doral's management because of significant issues found with Doral's loan modification programs and the fact that management was not addressing its flawed ALLL methodology. In addition, examiners reported that management compensation agreements did not provide proper incentives. The 2011 examination report was the first to identify the CEO as a dominant official. At the conclusion of the 2011 examination, FDIC officials, including NYRO senior management, presented the examination findings to Doral's Board, and found the Board's lack of understanding of the bank's condition surprising. A CO was issued to Doral in August 2012.

In 2013, Doral's management rating was downgraded to a "5" or critically deficient. The examination noted that management had made inadequate progress in complying with most of the CO provisions. Further, examiners were highly critical of compensation practices and recommended that the compensation committee reduce compensation to more reasonable and supportable levels. Examiners also expressed great supervisory concern with underwriting of TDRs.

The FDIC and the OCFI conducted a joint visitation of Doral during July 2014 to assess management activities to address weaknesses noted in the 2013 examination report. The visitation noted that management had taken certain corrective actions but a number of issues remained and all component ratings continued to be considered critically deficient. The 2014 examination reiterated criticisms of management and the Board.

Capital Ratings. Notwithstanding the minimum capital requirements, an FDIC-supervised institution must maintain capital commensurate with the level and nature of all risks to which the institution is exposed. As noted previously in this report, Puerto Rico's economic decline significantly impacted Doral's loan portfolio and earnings beginning in 2007. By 2008, earnings were considered to be deficient, and losses continued until Doral failed with earnings being downgraded to a "5" in 2013.

Doral's Capital Ratings, 2005 to 2014

Examination	Examiners' Assessment of Capital Adequacy	
2005-2009	2	**Satisfactory relative to risk profile.**
2010	3	Less than satisfactory. Level of capital does not fully support the institution's risk profile. Improvements needed, even if the institution's capital level exceeds minimum regulatory and statutory requirements.
2011	4	Deficient level of capital and viability may be threatened.
2013-2014	5	Critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

Source: Doral reports of examination and Examination Manual.

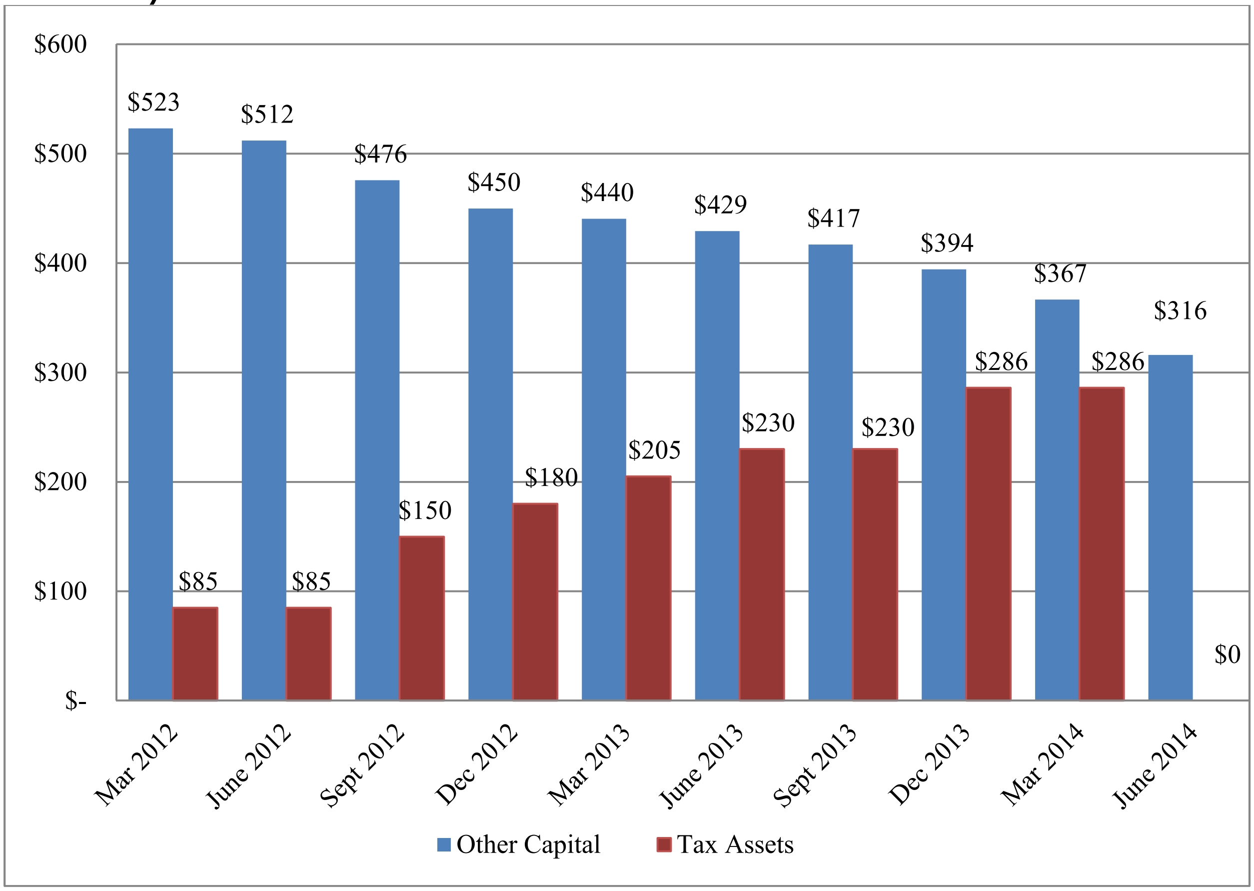
Despite the significant losses experienced by Doral, capital levels remained satisfactory because management was able to successfully offset losses by shrinking Doral's balance sheet. As discussed in the Causes of Failure section of this report, between 2007 and 2010, DFC also infused $554 million in capital in Doral. Although capital was deemed to be satisfactory in 2009, the examination report stated that high levels of non- and under-performing assets and operating losses posed risks. As depicted in the text box above, examiners deemed Doral's capital levels to be less than satisfactory in 2010. The 2010 examination report stated that, despite maintaining regulatory capital ratios in excess of minimum PCA requirements, existing capital levels did not fully support Doral's elevated risk profile. Notably, management did not agree with the downgrade and stated that the bank could absorb losses for several years at the current rate. The 2011 capital component downgrade reflected the increases in non-performing and adversely classified assets and the underfunded ALLL.

With the CO resulting from the 2011 examination, Doral was not permitted to accept, renew, or roll over any brokered deposits unless it received a brokered deposit waiver. The FDIC granted Doral five brokered deposit waivers between August 2012 and October 2013. In each case, the FDIC concluded that the brokered deposit waiver would not result in an unsafe or unsound practice. Doral submitted a sixth brokered deposit waiver on March 1, 2014, but it was withdrawn because its capital levels declined wherein Doral was not statutorily eligible for a waiver.

Hacienda Asset. The 2011 examination stated that the Hacienda tax receivable "has been determined to be eligible for Tier 1 Capital." As discussed earlier, the 2012 Hacienda agreement converted a DTA on the books of various DFC entities that was, for the most part, excluded from regulatory capital, into a prepaid tax asset that could be contributed to Doral and fully included in regulatory capital. This transaction was unusual; however, RMS' informal analysis of the transaction identified concerns about the language in the agreement and sought clarification from the Hacienda. The Hacienda confirmed the 2012 agreement was valid but did not provide any clarifying language that the tax refunds were not dependent on the bank earning future income. RMS personnel relied on the Hacienda's response in allowing a prepaid tax asset as capital. Information in the regional office's correspondence files indicated that the transaction was expected to be reviewed in more detail at the next examination.

During the 2013 examination, examiners performed a detailed review of the prepaid tax asset at Doral. Examiners obtained support for the amount of prepaid tax assets, considered whether the assets should be discounted to reflect the recovery timeframe, and asked the bank why it had not yet requested any refund from the Hacienda. In addition, examiners indicated uncertainty regarding the ultimate collectability of the prepaid taxes. In late August 2013, the FDIC's Boston Area Office, in consultation with the RMS Capital Markets Branch in Washington, concluded that the prepaid tax assets would not be criticized or deducted from capital. Correspondence referring to the November 5, 2013 examination close-out meeting with Doral management implied that this decision had still not changed. However, before the 2013 examination report was issued on April 30, 2014, RMS re-evaluated its position. Notably, at the time the 2012 agreement was signed, the prepaid tax assets totaled only 14 percent of Doral's Tier 1 Capital but increased to 42 percent by December 2013. Figure 6 illustrates the impact of the prepaid tax assets on Doral's Tier 1 Capital, which increased between March 2012 and June 2014.

Figure 6: Composition of Doral's Tier 1 Capital, March 2012 to June 2014 (Dollars in millions)



Source: OIG analysis of prepaid taxes, capital contributions, and capital balances in Doral's UBPR reports. The March 2014 figures reflect Tier 1 capital before the amendment to deduct the prepaid assets.

RMS personnel indicated that the increasing size of the tax assets in relation to the bank's capital, and the fact that the bank had not attempted to collect any refunds from the Hacienda, merited additional review of the capital treatment of these assets. Before the 2013 examination report was issued, in early 2014, RMS and Legal Division personnel, led by the RMS Chief Accountant, developed a comprehensive written analysis of the transaction, during which time RMS received notice that the Hacienda was re-evaluating, and might disallow the tax agreements. The 2014 analysis concluded that Doral's prepaid tax assets were, in substance, analogous to a contribution of a note receivable that does not provide meaningful capital support until collected in cash by Doral. RMS further concluded that, irrespective of the accounting treatment for the prepaid tax transactions at Doral, the prepaid taxes had characteristics that diminished their contribution to Doral's ability to absorb loss, including RMS' assertion that DFC retained effective control[10] over the prepaid tax assets. Therefore, pursuant to 12 C.F.R. §325.5(b), RMS ordered Doral to deduct the prepaid tax assets in determining regulatory capital.

[10] Doral, in a letter to RMS dated June 30, 2014, disputed this assertion.

The 2013 examination also discussed the general deterioration in the quality of capital downstreamed to Doral from DFC, including $106 million in mostly low-quality legacy residential loans that were previously held by DFC. The examination report also stated that negative earnings over the last 3 years had eroded $385 million in capital.

The last examination conducted of Doral prior to its failure began in September 2014. Examiners found that the overall condition of the institution remained critically deficient, and the bank's continued viability was in jeopardy. Capital levels in particular had declined to extremely critical levels and provided insufficient support given the extreme levels of risk inherent in the institution. All component ratings and the composite rating were "5." During this time, the primary concern was Doral's ability to maintain an adequate Capital level to continue operations. Since the prior examination, the Board had initiated and implemented a strategy, referred to as Project Abbey Road, in an attempt to refocus its business strategy to profitable U.S. operations. After the tax assets were disallowed, Project Abbey Road evolved into an effort to preserve capital ratios by shrinking assets. These sales included a subsidiary, nonperforming residential mortgages, residential OREO assets, commercial mortgage loans, and OREO properties. Doral decided not to sell certain assets because the terms would have resulted in a loss and negatively impacted capital. However, the proper accounting treatment of these loans remained in question when the examination was completed. Applying fair value accounting treatment to these assets would have significantly decreased capital levels. Examiners also reported that capital injections from DFC were insufficient to offset the high net operating losses of the bank.

Enforcement Actions

The following summarizes supervisory actions[11] taken and considered between 2005 and 2014:

March 2006 CO. During the 2005 examination, Doral stipulated to a CO issued by the FDIC and OCFI. The action became effective March 16, 2006, involved the accounting restatement issue related to mortgage-related transactions associated with another institution. The 2007 examination noted that management addressed all of the provisions of the order. The CO was terminated on January 14, 2008.

February 2008 BBR. To address weaknesses related to deterioration of asset quality and related impact on earnings identified by examiners in the 2007 examination, Doral's Board adopted a BBR on February 6, 2008. The BBR contained six provisions, including a provision requiring management to submit a comprehensive plan to the Board to reduce the amount of past due loans and classified assets. The 2008 examination report stated that management had substantially addressed all the provisions of the BBR, and the BBR was terminated on November 18, 2008.

November 2008 BBR. The Board adopted a BBR on November 17, 2008, to address asset quality and earnings concerns identified in the 2008 examination report. The 2009

[11] Our discussion does not include actions taken to address BSA and consumer compliance issues.

examination stated that management had substantially addressed all the provisions of the resolution. The BBR was terminated on July 29, 2010.

July 2010 BBR. Doral adopted another BBR on July 29, 2010, to record the bank's commitment to the prompt correction of deficiencies disclosed in the 2009 examination report. The BBR included six provisions to address all apparent violations of rules and regulations; charge off assets classified as loss; formulate a written plan for the reduction and collection of non-accrual loans; and develop and implement a written profit plan. Progress reports were required and submitted. The July 2010 BBR was terminated on August 26, 2011, and replaced by an MOU.

August 2011 MOU. The FDIC and OCFI issued an MOU to Doral, which became effective August 26, 2011, as a result of the 2010 examination. The MOU required the bank to address weaknesses noted by examiners that, among other things, required the bank to enhance procedures necessary to ensure appraisals were obtained in a timely manner; submit a comprehensive policy and methodology for determining the ALLL; and maintain policies, procedures, and processes that ensure adequate monitoring, including an independent review of the Bank's compliance with the OREO Policy. Notably, at the exit meeting, the Board indicated that although they had heard management's views on the topics discussed, they had "not previously heard examiners' views" and expressed interest in receiving the written report as soon as possible so they could fully understand regulatory concerns. This MOU was terminated on August 8, 2012 and replaced by a new CO.

August 2012 CO. Due to the significant weaknesses and the poor financial condition identified in the 2011 examination, Doral stipulated to a CO issued by the FDIC and OCFI effective August 8, 2012. The CO required Doral's Board and management to address the significant weaknesses mentioned in the Causes of Failure and Material Loss Section of this report, including: Board oversight and supervision, loan modification programs, loan review, appraisal practices, and ALLL methodology.

The CO remained in place until the bank failed, and FDIC and OCFI closely monitored Doral's responsiveness. Doral provided required progress reports. Examiners considered modifying the CO following the 2013 examination, but changes to the order were not formalized before the bank failed.

Supervisory Lessons Learned and Recommendation

We recognize that decisions related to assigning ratings and imposing appropriate supervisory actions involve considerable judgment. In this section of the report, we view the history with the benefit of hindsight and have the following observations related to the supervision of Doral:

Earlier Downgrades and Stronger Enforcement Actions May Have Been Prudent in 2009 and 2010. In our opinion, downgrading the management component and imposing an MOU in 2009 may have been prudent. We recognize that at this time, management was considered to be responsive to supervisory concerns and seeking outside capital.

However, considering the bank's overall condition and risk profile, greater skepticism of management's capability to develop and implement effective plans to address the significant deterioration in its loan portfolio and deficient earnings appears warranted.

Further, pursuing the MOU that was considered at the completion of the 2009 examination may have provided additional structure to guide corrective actions. In this case, Doral strongly disagreed with the imposition of the MOU, asserting that negative earnings trends were reversing and that any action requiring disclosure would impact the bank's ability to obtain capital. As part of the exit meeting, management outlined its strategies to increase capital and reduce non-performing loans. Nonetheless, according to the FDIC's *Formal and Informal Action Procedures Manual* (FIAP Manual), the FDIC generally uses MOUs instead of BBRs, especially when there is reason to believe the deficiencies noted during an examination need a more structured program or specific terms to effect corrective action. Notably, the FIAP Manual states an MOU may not be appropriate if an institution's performance shows significant improvement or there are strong mitigating circumstances. In these instances, a BBR may be more appropriate. However, the belief that an institution's management has recognized its errors and will improve is usually not grounds to forego an MOU.

With regard to the 2010 examination, a further downgrade of the management rating and the composite rating may also have been prudent. Again, greater skepticism may have been warranted regarding management's ability to address the significant deterioration of asset quality and concerns about Doral's credit risk management function, including deficiencies in its appraisal program and significantly deficient earnings. In our view, the downgrades would also have been consistent with the FDIC's forward-looking supervision approach, which was being emphasized at the time, given Doral's overall risk profile. The forward-looking supervision program formally adopted in 2011 focuses on risks when assigning ratings. In addition, the FDIC considered a CO at the conclusion of the 2010 examination, which included provisions for developing a Capital Plan. Such a plan at this juncture of the bank's decline might have forced the bank to seek outside sources of capital, rather than rely solely on the diminishing strength of DFC. Imposing a more formal action may have also impressed upon the Board the need to provide more oversight before Doral's financial condition worsened.

More Proactive and Structured Attention to Hacienda Asset Warranted. Also in retrospect, Doral's 2012 modification of the accounting, and correspondingly the capital treatment, of tax-related assets warranted an elevated level of scrutiny and a more proactive supervisory response, given the significance to Doral's tenuous condition. Although DFC did not immediately downstream all of the prepaid tax assets to Doral, DFC made it clear that it planned to do so, as needed. Consequently, although the prepaid tax asset did not initially represent a significant percentage of Doral's capital, given Doral's risk profile and negative earnings trends, it would become an increasingly significant component of capital.
A delay in providing a more comprehensive supervisory response did not significantly affect the timing of changes in the bank's PCA capital category; however, it did allow the bank to maintain capital levels in excess of the minimum levels in the CO until

June 2014, at which time the bank fell to *Undercapitalized*. The requirement for the bank to prepare a Capital Contingency Plan was therefore delayed by more than a year. In addition, RMS' initial decision may have affected the bank's motivation to pursue external sources of capital during the 2-year period in which the bank was allowed to include those assets in its regulatory capital calculations.

Regional Accountants are responsible for analyzing, and providing guidance and opinions on complex accounting issues and transactions, but internal guidance does not indicate to what extent the analysis should be documented; when the analysis should be elevated to a higher level within the organization, such as the RMS Washington Risk Management Policy Branch or Capital Markets Branch; or who has ultimate authority to conclude on the accounting or regulatory capital treatment for a specific transaction.

The lack of a process to ensure that the appropriate officials are included in the review of the issue and decisions are documented exposes the FDIC to criticism when initial decisions are ultimately reversed upon the completion of a more thorough review. Accordingly, we recommend the Director, RMS:

> **Recommendation 2.** Issue or revise policy guidance to document the requirements and responsibilities of Regional Accountants for developing and communicating a comprehensive analysis and related conclusions for complex and/or unique accounting transactions, or for escalating such analysis to the Washington Office Policy staff, as appropriate.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions.[12] Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to Doral, the FDIC properly implemented the applicable PCA provisions of Section 38 of the FDI Act. Doral was

[12] As of January 1, 2015, Part 325 is being replaced or has been superseded by Part 324, *Capital Adequacy of FDIC-Supervised Institutions*. Doral failed on February, 27, 2015, and substantially all supervisory actions with respect to Doral would have been implemented under Part 325. Accordingly, our work focused on Part 325.

considered *Well Capitalized* for PCA purposes through much of the MLR period, from the December 29, 2005, examination through the October 3, 2011, examination. Table 6 summarizes Doral's capital ratios relative to the PCA thresholds for *Well Capitalized* institutions during examinations and at other key points in time.

Table 6: Doral's Capital Ratios and Categories, 2011 to 2014

Examination or Event Date	Total Risk-Based Capital	Tier 1 Risk-Based Capital	Tier 1 Leverage Capital	Capital Classification Category
Well-Capitalized Thresholds	≥10%	≥6%	≥5%	
10/03/2011 Examination	13.28	12.01	7.79	*Well Capitalized*
8/08/2012 Consent Order	*	*	*	*Adequately Capitalized*
7/08/2013 Examination	8.23	6.97	5.29	*Adequately Capitalized*
5/08/2014 Ineligible Regulatory Capital	**	**	**	*Adequately Capitalized*
6/12/2014 PCA Notification	7.61	6.35	4.80	*Undercapitalized*
9/26/2014 PCA Notification	4.49	3.23	2.44	*Significantly Undercapitalized*
1/26/2015 PCA Directive	***	***	***	*Significantly Undercapitalized*
2/24/2015 PCA Notification	1.79	0.89	0.62	*Critically Undercapitalized*

Source: OIG Analysis of Doral examination reports, enforcement actions, and PCA-related activities.

* Doral became *Adequately Capitalized* because a CO was issued with a capital provision.
** The letter issued pursuant to § 325.5(b) of the FDIC Regulations (PCA) did not identify specific capital ratios.
*** The PCA Directive did not identify specific capital ratios.

The bank fell to *Adequately Capitalized* for PCA purposes on August 8, 2012, the effective date of the CO containing a provision outlining minimum capital levels that the bank was required to maintain. The bank remained *Adequately Capitalized* until the FDIC issued a PCA Notification on June 12, 2014, informing the bank that it had fallen to *Undercapitalized* as a result of the amended March 31, 2014, Call Report. That Call Report was amended as a result of a May 8, 2014, FDIC letter informing the bank it could no longer consider $286 million of prepaid tax assets eligible for treatment as regulatory capital. Subsequently, the FDIC notified the bank that it had fallen to *Significantly Undercapitalized* as of September 26, 2014, and finally to *Critically Undercapitalized* as of February 24, 2015, the issuance date of the 2014 examination report. The OCFI closed the bank on February 27, 2015.

Corporation Comments and OIG Evaluation

After we issued our draft report, management provided technical comments for our consideration, and we revised our report to address those comments, as appropriate. On August 31, 2015, the Director, RMS, provided a written response, dated August 28, 2015, to the draft report. That response is provided in its entirety as Appendix 4 of this report. In the response, RMS reiterated the OIG's conclusions regarding the causes of Doral's failure and concurred with the two recommendations.

A summary of the Corporation's corrective actions is presented in Appendix 5. The planned actions are responsive to the recommendations and the recommendations are considered resolved.

Objectives, Scope, and Methodology

Objectives

The performance audit objectives were to (1) determine the causes of Doral's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the bank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. We conducted our work from March 2015 through June 2015 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.

Scope and Methodology

The scope of our audit covered the period from the 2005 examination until Doral's failure on February 27, 2015.

To determine the causes of Doral's failure and the resulting material loss to the DIF, we reviewed relevant FDIC and OCFI examination reports, correspondence, and other analysis prepared by RMS and the Division of Resolutions and Receiverships (DRR). We also reviewed financial information about Doral and DFC. For example, we reviewed the FDIC's Failing Bank Case for Doral; examination, visitation, and TAQR reports prepared by the FDIC and the OCFI examiners; DFC annual reports on form 10-k; and financial data in Doral's UBPRs and Call Reports. We also reviewed reports and analysis prepared by a consulting firm hired by Doral. Further, we interviewed officials from the FDIC's NYRO, Boston Area Office, as well as officials from OCFI, to obtain their perspectives on the principal causes of Doral's failure. We also looked at various other records prepared by DRR relating to the bank's closure. To gain an understanding of Puerto Rico economic conditions and trends, we reviewed analysis prepared by the FDIC's Division of Insurance and Research and obtained economic indicators, such as current employment figures from available data on the U.S. Bureau of Labor Statistics Web site.

To evaluate the FDIC's supervision of Doral, including implementation of PCA, we assessed whether the supervisory approach and actions taken with respect to the bank were commensurate with its risk profile and relevant regulations, policies, and guidelines. Specifically, we:

- researched various banking laws and regulations to understand the requirements that were relevant to Doral in the context of the issues that contributed to the bank's failure;

- identified and reviewed RMS policies and procedures, including the Examination Manual, the FIAP Manual, and certain *Examination Modules* that were relevant to Doral and the supervisory actions taken with respect to the bank;

Objectives, Scope, and Methodology

- analyzed examination reports, visitation documentation, annual Puerto Rico supervisory strategies, as well as selected examination working papers, correspondence, and data maintained in the FDIC's Virtual Supervisory Information on the Net System (ViSION) and other information systems, to identify the timing and nature of supervisory actions taken to address risks at the bank;

- interviewed FDIC officials who had supervisory responsibility for Doral, including: RMS managers in Washington, D.C., the NYRO and Boston Area Office and FDIC examiners from the RMS Field Offices located in Braintree, Massachusetts; Jamesburg, New Jersey; Sunrise, Florida; and San Juan, Puerto Rico. We also contacted officials from the OCFI to discuss the historical perspective of the institution, its examinations, and other activities regarding the OCFI's supervision of the bank. Lastly, we interviewed officials at the Federal Reserve to discuss the historical perspective of its examinations of DFC.

We obtained data from various FDIC systems, such as ViSION and the Regional Automated Document Imaging System (RADD) but determined that information system controls were not significant to the audit objectives and, therefore, we did not evaluate the effectiveness of information system controls. We relied primarily upon examination reports, memoranda, and other correspondence, as well as testimonial evidence, to validate the system-generated information we relied upon. We did not perform specific audit procedures to assess the reliability of this information.

Regarding compliance with laws and regulations, we performed certain tests to determine whether the FDIC had complied with relevant PCA provisions in section 38 of the FDI Act. We also assessed compliance with aspects of the FDIC Rules and Regulations, including the examination frequency requirements defined in Part 337.12. The results of our compliance tests are discussed in this report, where appropriate.

We assessed the risk of fraud and abuse in the context of our audit objectives in the course of evaluating audit evidence. We reviewed available bank and FDIC documentation and inquired through OIG and through our interviews with RMS and OCFI officials about any existing investigation or possible presence of fraud within the bank.

Related Coverage of Financial Institution Failures

The OIG has issued a number of MLR reports and these reports can be found at www.fdicig.gov. In addition, the OIG issued an audit report, entitled *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), in December 2010. The objectives of the audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those in response to a May 2009 OIG memorandum and (2) identify trends and issues that have

Objectives, Scope, and Methodology

emerged from subsequent MLRs. Further, the OIGs of the FDIC, the Department of the Treasury, and the Board of Governors of the Federal Reserve System issued an evaluation report in September 2011, entitled, *Evaluation of Prompt Regulatory Action Implementation* (Report No. EVAL-11-006), which assessed the role and Federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *Prompt Corrective Action*, and section 39, *Standards for Safety and Soundness*) in the banking crisis. In addition, in October 2012, the FDIC OIG conducted a study entitled, *Acquisition, Development, and Construction Loan Concentration Study* (Report No. EVAL-13-001), that evaluated how certain banks with ADC loan concentrations survived the recent crisis and the supervisory actions taken for these institutions by the FDIC. The study identified factors that may help banks mitigate risks historically associated with ADC loan concentrations during periods of economic stress. The FDIC OIG also issued an evaluation report to the Congress, entitled *Comprehensive Study on the Impact of Failure of Insured Depository Institutions* (Report No. EVAL-13-002), in January 2013. This report addressed a number of topics relevant to institution failures, such as the evaluation and use of appraisals, the implementation of the FDIC's policy statement on CRE loan workouts, risk management enforcement actions, and examiner assessments of capital.

We considered each of the reports and the studies described above in planning and conducting our MLR of Doral.

Glossary

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of CRE that provide funding for acquiring and developing land for future construction, and that provide interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Annual Report on Form 10-K	An annual report required by the Securities and Exchange Commission that provides a comprehensive summary of a public company's performance. The report includes information such as company history, organizational structure, executive compensation, equity, subsidiaries, and audited financial statements, among other information.
Bank Board Resolution (BBR)	A BBR is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Bank Secrecy Act (BSA)	Congress enacted the BSA of 1970 to prevent banks and other financial service providers from being used as intermediaries for, or to hide the transfer or deposit of money derived from, criminal activity. The BSA requires financial institutions to maintain appropriate records and to file certain reports, including cash transactions over $10,000 via the Currency Transactions Reports. These reports are used in criminal, tax, or regulatory investigations or proceedings.

Glossary

Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Capital Contingency Plan	This plan outlines the bank's plan for the sale, merger, or liquidation of the bank in the event the primary sources of capital are not available within a specified number of days.
Charge-offs	Charge-offs are actual credit losses on individual retail credits that are recorded when the institution becomes aware of the loss.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Consent Order	A formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A consent order may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.

Glossary

Deferred Tax Asset (DTA)	DTAs are assets that reflect, for reporting purposes, amounts that will be realized as reductions of future taxes or as future receivables from a taxing authority. DTAs may arise because of specific limitations requiring that certain net operating losses or tax credits be carried forward if they cannot be used to recover taxes previously paid. These "tax carryforwards" are realized only if the institution generates sufficient future taxable income during the carryforward period. Effective April 1, 1995, the FDIC Capital Maintenance Regulation (Part 325) established limits on the amount of certain DTAs that may be included in Tier 1 Capital for risk-based and leverage capital purposes for state, nonmember banks. Under Part 325, specifically, section 325.5(g), for regulatory purposes, DTAs that are dependent upon future taxable income are limited to the lesser of: (1) the amount of such DTAs that the institution expects to realize within 1 year of the quarter-end report date, based on its projection of future taxable income for that year or (2) 10 percent of Tier 1 Capital before certain deductions are included.
Deposit Insurance Fund (DIF)	The DIF is a fund administered by the FDIC, the goal of which is to (1) insure deposits and protect depositors of FDIC-insured institutions and (2) resolve failed FDIC-insured institutions at the least cost (unless a systemic risk determination is made). The DIF is primarily funded from deposit insurance assessments.
Division of Resolutions and Receiverships	A division within the FDIC that has primary responsibility for resolving failing financial institutions and managing the resulting receiverships.
Division of Risk Management and Supervision	A division within the FDIC that has primary responsibility for issuing supervisory guidance to FDIC-supervised institutions and examiners and for performing examinations of FDIC-supervised institutions to assess their overall financial condition, management of policies and practices, and compliance with applicable laws and regulations.
Financial Holding Company	A financial entity engaged in a broad range of banking-related activities, created by the Gramm-Leach-Bliley Act of 1999. These activities include: insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, issuing or selling securitized interests in bank-eligible assets, and generally engaging in any non-banking activity authorized by the Bank Holding Company Act. The Federal Reserve Board is responsible for supervising the financial condition and activities of financial holding companies.
Forward–Looking Supervision Program	An RMS initiative to identify and assess the potential impact of an institution's new and/or growing risks and ensure early mitigation if necessary.

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Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: guarantor's related debt at other financial institutions, future economic conditions, as well as obtaining current and complete operating statements of all related entities. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan.
Interest Reserve Account	An interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance. Frequently, ADC loan budgets will include an interest reserve to carry the project from origination to completion and may cover the project's anticipated sellout or lease-up period.
Loan-to-Value	A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), is any estimated loss (as further defined in section (38(k)(2)(A)) to the DIF in excess of $50 million for losses that occur on or after January 1, 2014.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Nonaccrual Status	The status of an asset, often a loan, which is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status.

Glossary

Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 U.S.C., section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*.
Return on Assets	A ratio consisting of bottom line, after-tax net income, including securities gains/losses and extraordinary items, as a percentage of average assets.
Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).
Special Mention Assets	A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Glossary

Substandard	One of three types of classifications used by examiners to describe adversely classified assets. The term is generally used to describe an asset that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard assets are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.2(v), as: **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Tier 2 (Supplemental) Capital	Tier 2 capital is defined in Appendix A to Part 325 of the FDIC Rules and Regulations and is generally the sum of: • Allowances for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets; • Cumulative perpetual preferred stock, long-term preferred stock and related surplus; • Perpetual preferred stock (dividend is reset periodically); • Hybrid capital instruments; and • Term subordinated debt and intermediate-term preferred stock. • Net unrealized holding gains on equity securities.
Troubled Debt Restructuring (TDR)	A restructured or modified loan is considered TDR when the institution, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower in modifying or renewing a loan that the institution would not otherwise consider.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the FFIEC for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

Glossary

Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.
Wholesale Funding	Wholesale funding sources include, but are not limited to, federal funds, public funds, FHLB advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or certificate of deposit listing services. Financial institutions may use wholesale funding sources as an alternative to core deposits to satisfy funding and liability management needs.

Acronyms and Abbreviations

ACI	Adversely Classified Items
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ASC	Accounting Standard Codification
BBR	Bank Board Resolution
BSA	Bank Secrecy Act
CALL	Consolidated Reports of Condition and Income
CAMELS	**C**apital Adequacy, **A**sset Quality, **M**anagement Practices, **E**arnings Performance, **L**iquidity Position, and **S**ensitivity to Market Risk
CEO	Chief Executive Officer
CO	Consent Order
CRE	Commercial Real Estate
CPI	Customer Price Index
DFC	Doral Financial Corporation
DIF	Deposit Insurance Fund
DOT	Department of Treasury of Puerto Rico
DRR	Division of Resolutions and Receiverships
DTA	Deferred Tax Asset
FAS	Financial Accounting Standards
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIAP	Formal and Informal Action Procedures
FFIEC	Federal Financial Institutions Examination Council
FY	Fiscal Year
MOU	Memorandum of Understanding
NYRO	New York Regional Office
OCFI	Office of the Commissioner for Financial Institutions
OIG	Office of Inspector General
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
RADD	Regional Automated Document Imaging System
ROA	Return on Assets
RMS	Division of Risk Management Supervision
TAQR	Target Asset Quality Review
TDR	Troubled Debt Restructuring
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
U.S.C.	United States Code
ViSION	Virtual Supervisory Information on the Net

Corporation Comments

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C., 20429-9990 Division of Risk Management Supervision

August 28, 2015

TO: Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

FROM: Doreen R. Eberley /**Signed**/
Director

SUBJECT: Response to the Draft Audit Report Entitled, Material Loss Review of Doral Bank, San Juan, Puerto Rico (Assignment No. 2015-022)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's (FDIC) Office of Inspector General (OIG) conducted a Material Loss Review of Doral Bank, San Juan, Puerto Rico, which failed on February 27, 2015. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report (Report) received on July 31, 2015.

The underlying cause of Doral's failure was poor asset quality associated with weak underwriting and risk management practices and a severe and prolonged economic decline. Management strategies for handling its troubled loan portfolio were based on overly optimistic assumptions in light of actual economic conditions and proved to be ineffective over time. Further, the Board's oversight of management was inadequate in view of the size, financial condition, and challenges that faced Doral. Negative earnings from losses associated with the loan portfolio progressively eroded capital. Doral's holding company served as a source of strength for a period of time, but the amount and quality of capital provided proved to be insufficient. As Doral's financial condition deteriorated, numerous progressive supervisory actions were issued. Ultimately, Doral was not considered viable due to its weak capital position and was closed.

RMS concurs with the two recommendations included in the Report. The actions RMS will take to address the recommendations are briefly outlined below.

OIG's Audit Recommendation 1: *Update guidance for placing an institution on a targeted examination schedule to define dates to be used for purposes of complying with FDI Act examination frequency requirements.*

RMS agrees with the recommendation and is presently updating and consolidating its supervisory policies and procedures for large banks. As part of that effort, we will provide technical instructions for determining the examination "as of" date for an initial examination activity under the continuous examination program and for recording that information in our

Corporation Comments

inventory systems to demonstrate/document compliance with the examination frequency requirements of Section 10(d) of the FDI Act. RMS will complete this action by December 31, 2016.

OIG's Audit Recommendation 2: *Issue or revise policy guidance to document the requirements and responsibilities of Regional Accountants for developing and communicating a comprehensive analysis and related conclusions for complex and/or unique accounting transactions, or for escalating such analysis to the Washington Office Policy staff, as appropriate.*

RMS agrees with the recommendation and will draft guidance for how Regional Accountants should develop, document, and communicate analysis and related conclusions for complex and/or unique accounting transactions. The guidance will include procedures for escalating such analysis and conclusions to the Washington Office accounting and/or capital markets policy staff, as appropriate. RMS will complete this action by August 26, 2016.

Thank you for the opportunity to review and comment on the Report.

Summary of the Corporation's Corrective Actions

This table presents corrective actions taken or planned by the Corporation in response to the recommendations in the report and the status of the recommendations as of the date of report issuance.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Open or Closed[b]
1	As part of its efforts to update and consolidate its supervisory policies and procedures for large banks, RMS will provide technical instructions for determining the examination "as of" date for initial examination activity under the continuous examination program and for recording that information to document compliance with FDI Act examination frequency requirements.	12/31/2016	$0	Yes	Open
2	RMS will develop guidance for how Regional Accountants should develop, document, and communicate analysis and related conclusions for complex and/or unique accounting transactions. The guidance will include procedures for escalating matters to the Washington Office accounting and/or capital markets policy staff, as appropriate.	8/26/2016	$0	Yes	Open

[a] Resolved – (1) Management concurs with the recommendation, and the planned, ongoing, and completed corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Recommendations will be closed when (a) Corporate Management Control notifies the OIG that corrective actions are complete or (b) in the case of recommendations that the OIG determines to be particularly significant, when the OIG confirms that corrective actions have been completed and are responsive.