Office of Inspector General

Office of Audits and Evaluations
Report No. AUD-14-010

Material Loss Review of The Bank of Union, El Reno, Oklahoma

September 2014

Office of Inspector General

Executive Summary

Material Loss Review of The Bank of Union, El Reno, Oklahoma

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Why We Did The Audit

Section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, provides, in general, that if the Deposit Insurance Fund (DIF) incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency that includes a review of the agency's supervision of the institution. Section 38(k) establishes a material loss review (MLR) threshold of $50 million for losses that occur on or after January 1, 2014.

On January 24, 2014, the Oklahoma State Banking Department (OSBD) closed The Bank of Union (BOU), and the FDIC was appointed receiver. The FDIC notified the Office of Inspector General (OIG) on March 10, 2014, that BOU's total assets at closing were $243.7 million and that the estimated loss to the DIF was $70 million (or 29 percent of BOU's total assets). The FDIC OIG engaged KPMG LLP to conduct an MLR of BOU, the objectives of which were to (1) determine the causes of BOU's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of BOU, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

Background

BOU was chartered in 1900 in Union City, Oklahoma, and became insured by the FDIC in 1959. In 1992, the bank opened an office in El Reno, Oklahoma, which is located approximately 25 miles west of Oklahoma City. BOU relocated its main office to El Reno in 2007 while maintaining a branch office in Union City. The bank also maintained a loan production office in Oklahoma City. Union City Corporation (UCC), a one-bank holding company, owned all of BOU's stock. UCC's principal shareholders consisted of two siblings, each of whom owned 41 percent of UCC's stock. Neither sibling served on BOU's Board of Directors (Board). The Chairman of BOU's Board, who also served as the bank's President and Chief Executive Officer (CEO)—herein referred to collectively as the CEO—until November 2013, owned 15 percent of UCC's stock. UCC's remaining shares consisted of treasury stock.

BOU was a community bank that offered traditional banking services to local businesses and consumers. The bank's assets were centered in its loan portfolio, which had large concentrations in commercial and industrial (C&I) and agricultural loans. Most of BOU's C&I loans were made to rural cattle ranching and trucking businesses and were generally secured by assets such as livestock, equipment, single-family residences, and oil and gas leases. The bank's agricultural loans were made to cattle and farming operations and were primarily secured by livestock, ranch land, and trucking and farming equipment.

Audit Results

Causes of Failure and Material Loss

BOU failed primarily because its Board and management did not effectively manage the risks associated with the bank's aggressive growth and concentrations in C&I and agricultural loans, particularly in the livestock and trucking industries. Notably, BOU's lending function lacked adequate internal controls and sufficient seasoned loan officers to effectively manage the growth and complexity of the loan portfolio. For example, BOU lacked an adequate loan review function and credit grading system and frequently extended, deferred, and renewed loans without fully assessing the borrowers' ability to repay or adequately inspecting collateral, when appropriate. BOU's oversight and management of account overdrafts was also inadequate. These inadequate internal controls and certain actions of the CEO, as described later, clouded the true financial condition of BOU's loan portfolio. BOU also had a large and complex borrowing relationship that was not adequately administered, exposing the bank to significant credit risk and losses.

In general, BOU's Board was not sufficiently engaged in overseeing the bank's lending strategies and practices. The Board relied heavily upon the CEO, who exercised significant control over the lending function after the departure of senior lending officials in 2012 and made many of the decisions to originate and renew loans that were ultimately charged off. Significant financial deterioration in BOU's loan portfolio became apparent in 2012, and by the close of the 2013 joint examination, BOU's past due and nonaccrual loans totaled $157.8 million (or 54 percent of the loan portfolio). A substantial portion of these loans consisted of livestock and trucking loans. The bank recognized approximately $157.3 million in loan losses between January 2011 and the bank's failure, depleting its earnings and eroding its capital. The OSBD closed BOU due to the bank's inability to raise sufficient capital to support safe and sound banking operations.

The FDIC's Supervision of BOU

The FDIC, in coordination with the OSBD, provided ongoing supervisory oversight of BOU through regular onsite examinations, visitations, targeted reviews, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the bank's operations as early as 2008 and brought these risks to the attention of the institution's Board and management through examination reports, a visitation report, correspondence, and informal and formal enforcement actions. Such risks included inadequate Board and management oversight of the bank's complex structured credit products, lending practices (including loan administration and monitoring), and loan portfolio. With the benefit of hindsight, BOU's practice of continually extending, deferring, and renewing its livestock loans warranted an elevated level of scrutiny because such credits are typically structured as short-term loans that are paid off when the underlying collateral (i.e., livestock) is liquidated. When the structure and purpose of such loans are not properly aligned and enforced, the ability of bank management to effectively monitor the loans and identify performance problems can become compromised.

In the overall context of the examination findings, the February 2011 joint examination resulted in an upgrade to BOU's supervisory ratings, the termination of a Memorandum of Understanding, and the extension of the on-site examination interval from 12 to 18 months. At that time, BOU was experiencing rapid growth in its agricultural and C&I loans secured primarily by livestock and exhibited weak loan underwriting, administration, and monitoring practices, which were repeat concerns from the prior examination. The February 2011 report of examination recommended that BOU improve its loan administration practices with respect to extensions, deferrals, and renewals. However, BOU did not address those recommendations and continued its practice of extending, deferring, and renewing loans. In retrospect, it would have been prudent for the FDIC to have followed up with the bank to ensure these repeat concerns were promptly corrected. Further, a more comprehensive assessment of BOU's largest borrowing relationship—which primarily involved livestock loans—may have uncovered the bank's practice of using account overdrafts to keep the debt of certain borrowers within the relationship current. In addition, the report of examination was not critical of BOU's inadequate collateral inspections related to livestock loans.

Following the February 2011 joint examination, BOU's CEO assumed significant control over the lending function after the departure of three senior lending officials, and the bank's credit risk exposure increased. The October 2012 examination identified substantial loan losses, significant financial deterioration, and risky management practices that led to the OSBD promptly issuing an order against the bank. Among other things, the order resulted in a $40 million capital injection and significantly limited the bank's ability to extend new credit, helping to expose the degree to which certain borrowers of the bank, including its largest borrowing relationship, were unable to pay their debt. The regulators also raised concern about the independence and reliability of collateral inspections related to BOU's largest borrowing relationship. In response, bank management obtained a new inspection in December 2012 covering much of the collateral supporting the relationship's debt, although examiners later determined that the inspection's independence and reliability were questionable. These supervisory actions, however, could not reverse the substantial losses already embedded in the bank's loan portfolio, which led to the bank's failure.

The FDIC increased its supervisory monitoring and oversight of BOU following the October 2012 examination and, in June 2013, jointly issued a Consent Order with the OSBD against the bank. In conjunction with the October 2013 examination, the FDIC performed a targeted review that identified bank accounts administered by the CEO that were significantly and repeatedly overdrawn without proper approval during 2011 and 2012. In some cases, funds from overdrafts were used to make payments on existing loans and keep borrowers' debt current, and new loans were subsequently made to pay borrower overdrafts and service their debts. Such actions had the effect of clouding the financial condition of the borrowers and the performance of their loans.

Under the FDIC's forward-looking approach to bank supervision, which was re-emphasized to the FDIC examination workforce in 2010, banks with weak risk management practices are subject to increased supervisory analysis and a proactive supervisory response when risks are not properly managed. With respect to BOU's agricultural and C&I loans, including livestock loans, such a response could have involved holding the Board and management to a stronger commitment to address the weak lending practices identified during the February 2011 examination and more promptly following up to confirm that collateral inspections were adequate.

On July 16, 2014, the FDIC issued Financial Institution Letter (FIL)-39-2014, entitled *Prudent Management of Agricultural Credits Through Economic Cycles*. The FIL reminds FDIC-insured institutions that engage in agricultural lending to maintain sound underwriting standards, strong credit administration practices, and effective risk management strategies. These include, for example, analyzing the overall financial status of borrowers, including secondary repayment sources and collateral support levels; documenting all lien perfections; and conducting timely, independent collateral inspections. When an institution fails to adequately implement these lending practices, as was the case with BOU, there is an increased risk to the institution and, ultimately, the DIF.

Based on the supervisory actions taken with respect to BOU, the FDIC properly implemented the applicable PCA provisions of section 38.

Management Response

Subsequent to the issuance of KPMG's draft report, RMS and OSBD officials provided additional information for our consideration, and KPMG revised its report to reflect this information, as appropriate. In addition, the Director, RMS, provided a written response, dated September 5, 2014, to a draft of this report. In the response, the Director reiterated the causes of BOU's failure and the supervisory activities described in the report. The Director also agreed that, in retrospect, it would have been prudent to have followed up with the bank after the February 2011 joint examination to ensure that repeated concerns relative to loan extensions, deferrals, and renewals were properly corrected. In addition, the Director referenced guidance that was issued to FDIC-supervised institutions and examiners in 2010 and 2014 addressing prudent management practices for agricultural credits and described past and future examiner training initiatives focused on the evaluation of bank risk management practices.

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

Office of Audits and Evaluations
Office of Inspector General

DATE: September 10, 2014

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

/Signed/
FROM: Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

SUBJECT: *Material Loss Review of The Bank of Union, El Reno, Oklahoma* (Report No. AUD-14-010)

The subject final report is provided for your information and use. The report does not contain recommendations, thus a response was not required. However, the Division of Risk Management Supervision provided a written response dated September 5, 2014, to a draft of the report. We incorporated the response into Part II of the final report.

If you have questions concerning the report, please contact me at (703) 562-6352 or Mark Mulholland, Assistant Inspector General for Audits, at (703) 562-6316. We appreciate the courtesies extended to the Office of Inspector General and contractor staff.

Attachment

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Part I

Report by KPMG LLP

Material Loss Review
The Bank of Union
El Reno, Oklahoma

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

KPMG LLP

1676 International Drive
McLean, VA 22102

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KPMG LLP
1676 International Drive
McLean, VA 22102

September 10, 2014

Stephen M. Beard
Deputy Inspector General for Audits and Evaluations
Federal Deposit Insurance Corporation, Office of Inspector General
3501 Fairfax Drive
Arlington, VA 22226

Material Loss Review of the Failure of The Bank of Union, El Reno, Oklahoma

Dear Mr. Beard:

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review (MLR) of The Bank of Union (BOU or the bank), El Reno, Oklahoma. The objectives of the MLR were to (1) determine the causes of BOU's failure and the resulting material loss to the Deposit Insurance Fund (DIF) and (2) evaluate the FDIC's supervision of BOU, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the Federal Deposit Insurance Act (FDI Act). The enclosed report details the results of our review.

Consistent with the FDIC OIG's approach of considering the circumstances and lessons learned from individual bank failures in the broader context of other bank failures, our report contains no recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in MLRs, the FDIC OIG periodically communicates those matters to FDIC management and makes recommendations, as warranted.

We conducted our work as a performance audit in accordance with Generally Accepted Government Auditing Standards. These standards require that we plan and conduct the performance audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The information included in this report was obtained during our fieldwork, which occurred during the period March 2014 through July 2014.

Very truly yours,

KPMG LLP

Why a Material Loss Review Was Performed

Section 38(k) of the FDI Act, as amended, provides, in general, that if the DIF incurs a material loss[1] with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency that includes a review of the agency's supervision of the institution. The report is required to be completed within 6 months of it becoming apparent that a material loss has been incurred. Section 38(k) establishes an MLR threshold of $50 million for losses that occur on or after January 1, 2014.

On January 24, 2014, the Oklahoma State Banking Department (OSBD) closed BOU, and the FDIC was appointed receiver. The FDIC's Division of Finance notified the OIG on March 10, 2014, that BOU's total assets at closing were $243.7 million and that the estimated loss to the DIF was $70 million (or 29 percent of BOU's total assets). Accordingly, the FDIC OIG engaged KPMG to conduct an MLR, the objectives of which were to (1) determine the causes of BOU's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of BOU, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.[2] Appendix 1 contains additional information about our objectives, scope, and methodology; Appendix 2 contains a glossary of key terms; and Appendix 3 contains a list of acronyms.

Background

BOU was chartered in 1900 in Union City, Oklahoma, and became insured by the FDIC in 1959. In 1992, the bank opened an office in El Reno, Oklahoma, which is located approximately 25 miles west of Oklahoma City. BOU relocated its main office to El Reno in 2007 while maintaining a branch office in Union City. The bank also maintained a loan production office in Oklahoma City.

BOU was a community bank that offered traditional banking services to local businesses and consumers. Union City Corporation (UCC), a one-bank holding company, owned all of BOU's stock. UCC's principal shareholders consisted of two siblings, each of whom owned 41 percent of UCC's stock. Neither sibling served on BOU's Board of Directors (Board). The Chairman of BOU's Board, who also served as the bank's President and Chief Executive Officer (CEO)—herein referred to collectively as the CEO—until November 2013, owned 15 percent of UCC's stock. UCC's remaining shares consisted of treasury stock.

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

[2] In conducting this performance audit and preparing the report, KPMG relied primarily on BOU's records and on information provided by the FDIC OIG, the Division of Risk Management Supervision (RMS), and the Division of Resolutions and Receiverships (DRR). Within the FDIC, RMS performs examinations of FDIC-supervised institutions to assess their overall financial condition, management of policies and practices, and compliance with applicable laws and regulations, as well as issues related guidance to institutions and examiners. DRR has primary responsibility for resolving failing financial institutions and managing the resulting receiverships.

BOU's assets were centered in its loan portfolio, which had large concentrations in commercial and industrial (C&I) and agricultural loans. As of November 8, 2013, C&I and agricultural loans comprised 51 percent and 31 percent, respectively, of the bank's loan portfolio. Table 1 provides selected information pertaining to BOU's financial condition and operating results as of September 30, 2013, and for the 5 preceding calendar years.

Table 1: Selected Financial Information for BOU, 2008-2013

Financial Data ($000s)	9/30/13	12/31/12	12/31/11	12/31/10	12/31/09	12/31/08
Total Assets	$331,357	$382,120	$381,170	$341,182	$308,572	$233,810
Total Loans	$293,074	$316,718	$340,982	$290,386	$261,727	$177,165
Annual Loan Growth Rate	(7.5%)*	(7.1%)	17.4%	11.0%	47.7%	23.1%
Total Deposits	$328,774	$348,610	$344,190	$309,533	$282,912	$182,424
Agricultural Loans/Total Capital	1,031%**	151%	129%	136%	144%	150%
C&I Loans/Total Capital	3,088%**	383%	403%	357%	470%	351%
Noncurrent Loans/Gross Loans	51.43%	14.37%	2.34%	1.96%	0.23%	0.49%
Net Interest Margin	0.28%*	4.91%	5.05%	4.90%	4.66%	4.20%
Return on Average Assets	(10.63%)*	(9.30%)	2.19%	2.29%	(0.33%)	0.37%

Source: KPMG analysis of Uniform Bank Performance Reports (UBPR) for BOU.
* For the 9 months ending September 30, 2013.
** The significant increase in ratios is attributable to a precipitous decrease in capital rather than an increase in loans.

Causes of Failure and Material Loss

BOU failed primarily because its Board and management did not effectively manage the risks associated with the bank's aggressive growth and concentrations in C&I and agricultural loans, particularly in the livestock and trucking industries. Notably, BOU's lending function lacked adequate internal controls and sufficient seasoned loan officers to effectively manage the growth and complexity of the loan portfolio. For example, BOU lacked an adequate loan review function and credit grading system and frequently extended, deferred, and renewed loans without fully assessing the borrowers' ability to repay or adequately inspecting collateral, when appropriate. BOU's oversight and management of account overdrafts was also inadequate. These inadequate internal controls and certain actions of the CEO, as described later, clouded the true financial condition of BOU's loan portfolio. BOU also had a large and complex borrowing relationship that was not adequately administered, exposing the bank to significant credit risk and losses.

In general, BOU's Board was not sufficiently engaged in overseeing the bank's lending strategies and practices. The Board also relied heavily upon the CEO, who exercised significant control over the lending function after the departure of senior lending officials in 2012 and made many of the decisions to originate and renew loans that were ultimately charged off. Significant financial deterioration in BOU's loan portfolio became apparent in 2012, and by the close of the October 2013 joint examination, BOU's past due and nonaccrual loans totaled $157.8 million (or 54 percent of the loan portfolio). A substantial portion of these loans consisted of livestock and trucking loans. The bank recognized approximately $157.3 million in loan losses between January 2011 and the bank's failure, depleting its earnings and eroding its capital. The OSBD closed BOU on January 24, 2014, due to the bank's inability to raise sufficient capital to support safe and sound banking operations.

Board and Management Oversight

The FDIC's *Risk Management Manual of Examination Policies* (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. Executive officers, such as the President and CEO and the Chief Financial Officer, have primary responsibility for managing the day-to-day operations and affairs of the bank. Further, ensuring appropriate corrective actions are taken in response to regulatory concerns is a key responsibility of the Board.

BOU's Board and management did not provide effective oversight or supervision of the bank's critical business functions, particularly the lending function, and did not ensure that internal controls and risk management practices were commensurate with the bank's risk profile. As described below, and in subsequent sections of this report, BOU's Board and management:

- Allowed the bank to engage in rapid loan growth and develop concentrations in livestock and trucking loans without adequate risk management practices. The risk associated with these loans was further elevated by the bank's exposure to a large and complex borrowing relationship that lacked adequate underwriting and administration.

- Did not adequately underwrite, administer, or monitor its loans. Among other things, BOU's management did not establish and implement adequate internal controls over the lending function, such as an independent loan review process, and frequently extended, deferred, and renewed loans without fully assessing the borrowers' ability to repay or adequately inspecting collateral.

- Failed to fully address regulatory recommendations dating back to 2010, including repeat concerns pertaining to the bank's concentration risk management practices and liberal loan renewals and extensions.

- Failed to appropriately identify, measure, and provide for the level of deterioration in the bank's loan portfolio.

- Did not maintain capital at levels that were commensurate with the bank's risk profile.

An FDIC targeted review conducted in conjunction with the October 2012 examination found that BOU's CEO was the controlling manager over the bank and delegated little authority to other management team members. The review also found that Board meeting minutes indicated that the Board generally ratified matters presented to the directors and rarely opposed or probed the bank's policies, procedures, or credit decisions. In addition, the CEO occasionally presented information to the Board about certain borrowing relationships and the bank's overall lending strategy, but in some cases subsequent management actions would deviate from the materials presented. For example, the CEO reported to the Board in June 2010 that the bank's exposure to cattle lending would be lowered. The CEO also reported in October 2010 that certain bank customers had been notified that cattle lending would be significantly reduced in 2011. However, the bank's lending in the cattle industry actually increased substantially in 2011 and 2012.

The *Report of the Study of the Management and Staffing of The Bank of Union and Proposed Management Plan*, prepared by an outside consultant on behalf of BOU in November 2013, described weaknesses in the Board's oversight, and the CEO's management, of the bank's lending function. The report, which was required by a Consent Order issued by the FDIC and OSBD in June 2013, stated, among other things, that:

- The bank did not have the requisite number of seasoned loan officers required to effectively manage the loan portfolio. This was particularly evident for the bank's non-performing loans, for which BOU did not have a sufficient number of experienced loan workout officers. Further, the expansion of the bank between 2008 and 2012 required the management capabilities and focus of a larger and more competent lending function.

- Information in the bank's UBPR regarding rapid growth in the loan portfolio and related information indicated possible future problems regarding loan management and oversight capacities and practices within the bank. The study stated that growth in the loan portfolio would have indicated a corresponding need to strengthen the bank's lending staff, loan policies, credit analysis, and exception management. Further, the bank's reported earnings likely masked issues that should have been raised and considered by the Board and management.

- While Board members appeared to have the requisite knowledge and business experience to discharge their duties, they did not have specific banking experience (with the exception of one director), especially in the area of sophisticated loan administration. Consequently, Board members may not have completely recognized the risk that accompanied the bank's growth or required discussions and decisions regarding such growth. According to the study, a lack of summary analytical reports routinely presented to the Board appears to have further hampered effective oversight of the bank, including the loan portfolio.

- Trust was placed in certain borrowers that was not substantiated by credible financial information and independent inspections of collateral.

- The CEO's compensation appeared to be high as a result of a determination by outside Board members that was based mainly on the apparent earnings from the bank's expansion.

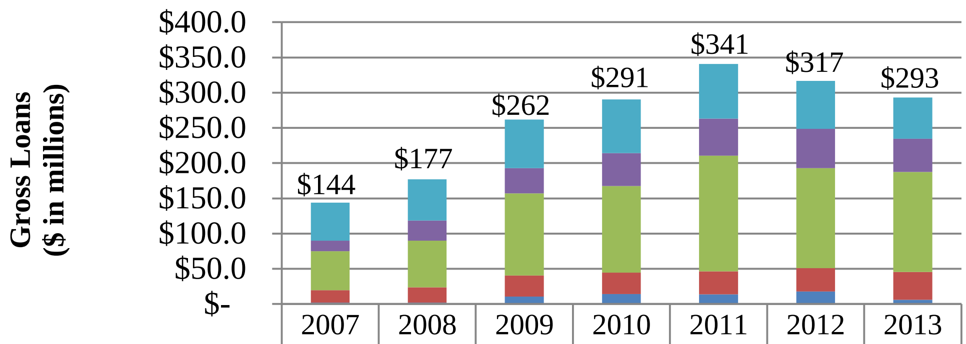
- The bank should appoint a new President and CEO.

Loan Growth and Concentrations

BOU pursued an aggressive loan growth strategy centered in C&I and agricultural lending in the years before the institution's financial decline. During the 4-year period ended December 31, 2011, the bank's total loan portfolio grew by 137 percent. According to a third-party loan portfolio valuation performed in December 2013, most of the bank's C&I loans were made to rural cattle ranching and trucking businesses and were generally secured by assets such as livestock, equipment, single-family residences, and oil and gas leases. The bank's agricultural loans were made to cattle and farming operations and were primarily secured by livestock, ranch land, and trucking and farming equipment.

BOU's loan growth significantly exceeded the bank's internal projections. For example, BOU projected that its loan portfolio would grow by 2 percent in 2010. However, the loan portfolio actually grew by 11 percent that year. Further, while BOU's internal projections in 2010 indicated that growth would be substantially reduced based upon then-current trends and management's goals and objectives, BOU's loan portfolio grew another 17 percent in 2011. Figure 1 illustrates the general composition of BOU's loan portfolio in the years preceding the institution's failure.

Figure 1: Composition and Growth of BOU's Loan Portfolio, 2007-2013



	2007	2008	2009	2010	2011	2012	2013
All Other Loans	$54.0	$58.6	$69.0	$76.1	$77.7	$67.9	$58.2
Agricultural Loans	$14.7	$28.4	$35.7	$46.9	$52.5	$56.0	$47.4
Commercial and Industrial	$55.7	$66.4	$116.3	$122.8	$164.3	$141.9	$142.0
Other CRE	$17.5	$21.6	$30.3	$30.5	$32.6	$33.2	$39.6
ADC	$2.0	$2.1	$10.4	$14.2	$13.9	$17.7	$5.9

Source: KPMG analysis of Call Reports for BOU.
Note: Dollar amounts are as of calendar year end, except for 2013, which are as of September 30, 2013. Totals may not match sum of loan categories due to rounding.

As shown in Table 2, BOU's concentrations in C&I and agricultural loans relative to total capital were high.[3] However, the bank's concentration risk management practices were not adequate, exposing the bank to elevated credit risk. For example, reports of examination issued from 2010 to 2013 stated that BOU's lending policy did not adequately address concentration monitoring controls and requirements and did not establish Board-approved limits or acceptable levels of concentration in relation to the bank's capital levels.

Table 2: BOU's C&I and Agricultural Loan Concentrations

Year-End	C&I Loans as a Percentage of Total Capital	Agricultural Loans as a Percentage of Total Capital
2008	351%	150%
2009	470%	144%
2010	357%	137%
2011	403%	129%
2012	383%	151%

Source: KPMG analysis of UBPRs for BOU.

As described below, the risk associated with BOU's loan concentrations was exacerbated by large and complex borrowing relationships that lacked adequate underwriting and administration.

[3] The FDIC defines concentrations as obligations representing 100 percent of Tier 1 Capital by industry, product line, or collateral type, as well as 25 percent or more of Tier 1 Capital to an individual or interrelated group of borrowers.

Large Borrowing Relationships

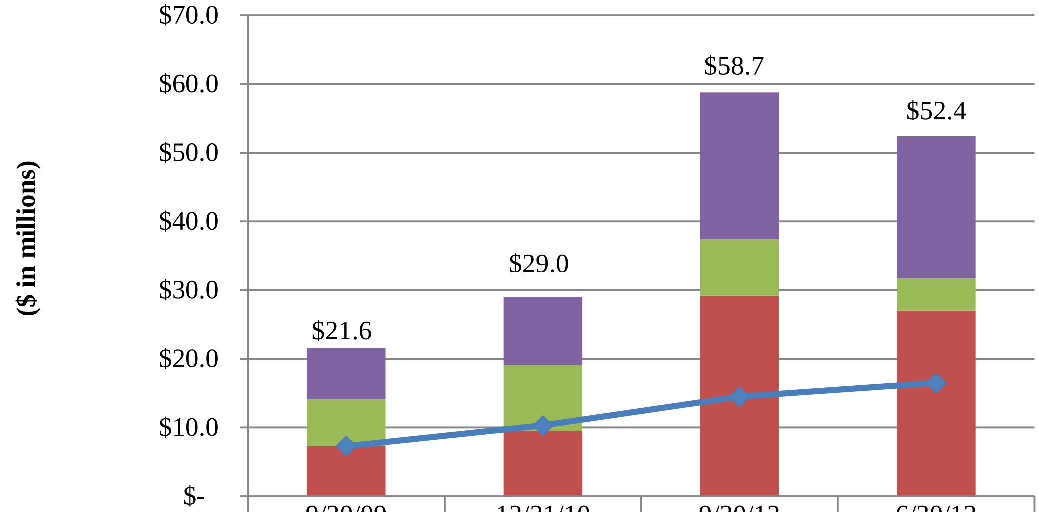
The October 2012 report of examination identified seven borrowing relationships that collectively totaled $98.8 million (or 317 percent of the bank's Tier 1 Capital). Five of these relationships totaling $78.5 million were either adversely classified or listed as special mention in the report of examination, exposing the bank to significant credit risk.

One of the large borrowing relationships was particularly risky. Specifically, the bank made numerous loans to various entities controlled by a group of three related borrowers who had a longstanding relationship with the bank. BOU's lending to this group of borrowers began as cattle loans but later expanded to include trucking loans. At the time of the January 2010 FDIC examination, the borrowing relationship accounted for 101 percent of the bank's Tier 1 Capital. The bank's exposure to the relationship continued to expand and the concentration grew to 188 percent of Tier 1 Capital at the October 2012 FDIC examination. As of December 2013, the borrowing relationship consisted of 73 loans totaling $51.3 million (or 17.8 percent of the bank's total loan portfolio).

Figure 2 illustrates BOU's exposure to the relationship relative to the bank's legal lending limits from 2009 to 2013. Examiners cited the bank for apparent violations of the Oklahoma Banking Code relative to limitations on maximum indebtedness at the 2012 and 2013 examinations, reflecting negatively on the Board and management's ability to operate the bank in a safe and sound manner.[4]

[4] Examiners determined that while the borrowing entities did not exceed the legal lending limit on an individual basis, the relationship between the individuals and their respective companies met the "common enterprise" definition as stated in the "Summary of Lending Limit Rules for State Chartered Banks" provided by the OSBD. While the bank's total borrower exposure appears to have exceeded the legal lending limits prior to 2012, it is unclear whether the borrower relationship met the "common enterprise" definition during that timeframe.

Figure 2: Borrower Exposure Relative to Legal Lending Limits, 2009-2013



	9/30/09	12/31/10	9/30/12	6/30/13
Borrower 1	$7.5	$9.9	$21.4	$20.7
Borrower 2	$6.8	$9.6	$8.2	$4.7
Borrower 3	$7.3	$9.5	$29.2	$27.0
Legal Lending Limit	$7.3	$10.3	$14.5	$16.5

Source: Borrower exposure levels are based on KPMG analysis of reports of examination for BOU. Legal lending limit amounts are based on KPMG analysis of Call Reports for BOU.
Note: Borrower exposure levels and the bank's legal lending limit amounts are based on the examination as-of dates for the years listed. Some totals may not agree due to rounding.

The October 2012 report of examination described a number of serious concerns related to the administration of this borrowing relationship. Among other things, the report noted that BOU frequently renewed the loans without obtaining independent and reliable collateral inspections, adequate financial information on the borrowers and their businesses, or the approval of the bank's Board. In addition, BOU often capitalized interest when renewing loans without reducing principal.[5] Further, lien searches performed by the FDIC in late 2012 found that the bank's position may have been subordinate to other parties and that the net worth of the borrowers failed to provide a secondary source of repayment.

In December 2012, BOU reportedly obtained a collateral inspection for the cattle securing much of the relationship's debt. However, the October 2013 joint examination report questioned the legitimacy of the inspection and cited repeat concerns regarding the bank's administration of the relationship. Examiners concluded that it was highly probable that BOU was financing the operating losses of the borrowers' businesses based, in part, on the bank's financing of large overdrafts, frequent renewals of short-term notes, and capitalizing interest. Based on the severe delinquency of the relationship and management's failure to verify the bank's collateral position, examiners considered $50.7 million (or 97 percent of the relationship) as a loss. This loss

[5] Capitalizing interest on a loan increases the bank's credit risk exposure because it serves to increase debt without a corresponding increase in the collateral that secures the loan.

represented 43 percent of the $118.2 million in total loan losses identified by examiners during the October 2013 joint examination.

Lending Practices

Poor loan underwriting, administration, and monitoring were significant factors in the asset quality problems that developed at BOU. As previously stated, BOU's expansion in the years preceding its financial decline required the management capabilities and focus of a larger and more competent lending function. Notably, BOU's efficiency ratio placed the bank in the top 5 percent of its peer group from 2009 to 2012.[6] Such ratios indicate that BOU was able to maintain low overhead expenses in relation to its revenue and may have been a leading indicator that key business operations, such as the lending function, were not being adequately resourced to support the bank's aggressive growth strategy.

The Examination Manual indicates that agricultural lending requires many of the same fundamental underwriting standards as other forms of lending, while also involving some unique requirements that warrant emphasis. Items pertinent to agricultural lending include the availability of sufficient financial information to make an informed credit decision, adequate loan structure that correlates to the purpose of the credit, sufficient collateral support, and sufficient cash flow analysis. The Examination Manual also highlights aspects of prudent loan administration, including the importance of periodic on-site inspections, verifications, and documentation of pledged collateral, as well as adequate procedures to ensure sales proceeds of the collateral are applied to the associated debt. With respect to renewing agricultural loans, the Examination Manual states that banks must take prudent steps to ensure loans are paid on an appropriate basis and highlights the importance of the borrower's financial strength and current inspection reports to support credit decisions.

Further, the FDIC's Financial Institution Letter (FIL), entitled *Prudent Management of Agricultural Credit Through Farming and Economic Cycles* (FIL-85-2010, dated December 14, 2010), states that financial institutions engaging in agricultural lending should implement a prudent credit risk management process. Such a process should place strong emphasis on borrower cash flow and repayment capacity and not place undue reliance on collateral for repayment.

As discussed below, BOU's management did not adequately manage or administer the loan portfolio and engaged in risky lending practices in the years leading up to the bank's failure. Examiners identified loan administration weaknesses as early as the January 2010 FDIC examination. However, BOU's Board and management did not fully address those concerns. Subsequent examinations became increasingly critical of BOU's lending

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[6] For 2008, BOU's peer group consisted of insured commercial banks having assets between $100 million and $300 million, with two or fewer full-service banking offices and located in a metropolitan statistical area. For 2009 to 2013, BOU's peer group consisted of insured commercial banks having assets between $300 million and $1 billion.

practices as the bank's financial deterioration and weak risk management practices became more apparent and widespread.

Loan Extensions, Deferrals, Renewals, and Capitalization of Interest

The January 2010 report of examination raised concerns about BOU's liberal loan extensions, deferrals, and renewals and its practice of capitalizing interest. The report noted that such practices can cloud the true performance and delinquency status of the loan portfolio. Concerns about loan extensions, deferrals, and renewals were reiterated in the February 2011 report of examination. The October 2012 report of examination stated that management had concealed performance weaknesses in the loan portfolio through liberal loan extensions and renewals, and the capitalization of interest. The report also recommended that $40.7 million in loans be classified as nonaccrual. In addition, the report identified a number of loan underwriting weaknesses, including:

- a lack of comprehensive financial analysis, including global cash flow analysis, of borrowers' ability to repay;
- a failure to establish and enforce well-defined repayment programs consistent with borrower cash flow and repayment capacities;
- extensions or renewals of credit to inadequately capitalized businesses and borrowers lacking sufficient equity positions in pledged collateral; and
- an over-reliance on collateral to repay loans.

Further, the FDIC's targeted review conducted in 2012 found that BOU's CEO routinely granted new loans, renewals, and extensions of credit without evidence of Board approval and, in some cases, in contravention of the bank's policy regarding the CEO's lending authority and the bank's legal lending limit.

Management of Overdrafts

The October 2012 report of examination stated that BOU's oversight and management of overdrafts was "non-existent" and classified overdraft accounts aggregating $1.3 million as loss. Examiners recommended that BOU establish prudent monitoring procedures to limit habitual overdrafts on problem accounts and charge off problem accounts at least quarterly. In addition, although BOU's policy was to require dual approval of overdrafts exceeding $5,000, the policy was not followed. A targeted review of overdrafts by the FDIC in December 2013 found that accounts administered by the CEO were significantly and repeatedly overdrawn without proper approval during 2011 and 2012. In some cases, funds from overdrafts were used to make payments on existing loans and keep borrowers' debt current, and new loans were subsequently made to pay borrower overdrafts and service their debts. Such actions had the effect of clouding the financial condition of the borrowers and the performance of their loans.

The June 2013 Consent Order limited customer overdrafts to $5,000 and effectively ended BOU's liberal overdraft practices. As a result, certain borrowers were no longer able to keep their debt current and substantial charge-offs of interest occurred. Based on our review of BOU's records, it appears that frequent overdrafts for one of the borrowers in the large lending relationship described earlier date back to at least 2009, as evidenced by large overdraft fees for the borrower during that period.

Loan Monitoring and Allowance for Loan and Lease Losses Methodology

BOU lacked an adequate loan review function and credit grading system. As a result, the bank experienced numerous and large credit downgrades during examinations. The January 2010 report of examination recommended that BOU address weaknesses in the bank's credit grading system, and the February 2011 report of examination stated that BOU's loan review function was not being effectively implemented, as evidenced by the continued identification of adversely classified assets by examiners. Examiner concerns with BOU's loan review function continued during the October 2012 FDIC examination, wherein more than 96 percent of the $108.6 million in adversely classified loans identified by examiners had not been internally identified by the bank. BOU's Board was instructed during the October 2012 and October 2013 examinations to establish a comprehensive written loan review system that would promptly identify loans with credit weaknesses, identify trends and potential problem areas, verify the accuracy and timeliness of internal credit grades, and provide other essential information for determining the appropriateness of the Allowance for Loan and Lease Losses (ALLL).

According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. As a result, each institution is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the ALLL. Examiners noted during the October 2012 FDIC examination that BOU's ALLL methodology was inadequate and determined that an additional provision of $49.4 million was necessary to restore the ALLL to a minimally acceptable level. Examiners noted repeat weaknesses in the ALLL methodology during the October 2013 joint examination and determined that an additional provision of $96.9 million was needed to restore the ALLL to an appropriate level.

Credit Administration

The Examination Manual states that the nature of asset-based lending in the agricultural industry requires a high level of administration and oversight to ensure the viability and collectability of the loans. Further, maintaining current and complete borrower financial information and collateral valuations is critical to assessing the credit-worthiness of borrowers and making informed credit decisions.

The January 2010 report of examination stated that loan files for 59 percent of the total volume of loans reviewed by examiners lacked certain relevant documentation. The majority of exceptions related to a lack of current financial information on borrowers.

Subsequent reports of examination continued to criticize BOU's management for failing to obtain current financial information for many of its loans. In addition, a third-party loan portfolio valuation performed in December 2013 identified loans collateralized by inventory, such as livestock, vehicles, and mobile homes, that lacked any evidence of monitoring or surveillance. The portfolio valuation also found that loan files lacked credit origination memoranda to substantiate the bank's lending decisions and document the borrower's financial status and the value of collateral. Further, although much of the C&I portfolio was collateralized by business inventory, loan files rarely contained collateral listings or valuations.

Our review of selected loans identified many of the same loan underwriting and credit administration weaknesses cited by regulators in the final years of BOU's operations. Among other things, our review identified loan files that contained collateral "listings" that appeared to be prepared by the borrower but did not contain independent, professional collateral inspections or documentation supporting collateral values. In addition, financial information was often prepared by the borrower, was out-of-date, and/or did not evidence analysis of the borrower's ability to repay the loans. It was not until November 2012 that BOU's Board minutes noted a change in bank policy requiring annual financial statements prepared by Certified Public Accountants for certain borrowers and more extensive supporting documentation for livestock inspections.

Decline in the Loan Portfolio

The extent of credit losses and impaired financial condition of BOU's loan portfolio became apparent in 2012, as reflected in the increase of past due and nonaccrual loans from \$8.8 million at year-end 2011 to \$87.5 million at year-end 2012. By the close of the 2013 joint examination, BOU's past due and nonaccrual loans totaled \$157.8 million, the majority of which was comprised of agricultural and C&I loans primarily secured by livestock. Based on our analysis of documentation pertaining to BOU's failure, we determined that the bank charged off approximately \$157.3 million in loans from January 2011 until the bank's failure. Approximately \$125.3 million (or 80 percent) of that amount related to loans originated or renewed in the time period between April 2011 and the issuance of the Consent Order in June 2013.[7]

Table 3 reflects BOU's adversely classified assets as reported by each of the five examinations that were performed from 2008 to 2013. Notably, only \$2.5 million of the approximately \$101 million in additional adverse loan classifications identified by examiners during the October 2012 examination consisted of new credit extensions. The remainder consisted of existing borrower relationships that had not been previously classified or had been classified less severely.

[7] As discussed later in this report, the FDIC and OSBD terminated a then-existing Memorandum of Understanding (MOU) with the bank in April 2011.

Table 3: BOU's Adversely Classified Assets, 2008-2013 Examinations

Classification ($000s)	June 2008	January 2010	February 2011	October 2012	October 2013
Substandard	$1,758	$5,468	$9,028	$71,228	$39,662
Doubtful	$0	$0	$96	$0	$5,918
Loss	$10	$986	$179	$38,783	$118,208
Total	$1,768	$6,454	$9,303	$110,011	$163,788

Source: KPMG's analysis of reports of examination for BOU.

Capital Levels Relative to Loan Growth

The Examination Manual states that institutions should maintain capital commensurate with the level and nature of risks to which they are exposed and the ability of management to identify, measure, monitor, and control those risks. Further, the amount of capital necessary for safety and soundness purposes may differ significantly from the amounts needed to maintain a *Well Capitalized* or *Adequately Capitalized* position for purposes of PCA.

BOU relied on one of UCC's principal shareholders for capital support during the period covered by our review. For example, the shareholder made capital injections of $5 million and $40 million in January 2010 and December 2012, respectively, to help cover the bank's losses and maintain its *Well Capitalized* position.[8] Nevertheless, BOU did not maintain capital at levels that were commensurate with its risk profile. Figure 3 reflects the trends in BOU's Total Risk-Based Capital ratios and annual growth rates relative to peer for the 4-year period ending December 31, 2011. As reflected in the figure, the bank's capital ratios were consistently below peer despite the bank having a growth rate that was significantly above peer. As mentioned earlier, BOU also had high concentrations in C&I and agricultural loans. Had BOU maintained higher capital levels, loan growth may have been constrained and losses to the DIF may have been mitigated to some extent.

[8] As described later, BOU purchased complex structured credit products called collateralized mortgage obligations (CMO) in 2008. Although not considered a capital injection, the shareholder significantly reduced the bank's risk exposure to the CMOs by purchasing a resecuritization of the securities in 2009.

Figure 3: BOU's Total Risk-Based Capital and Growth Rate Compared to Peer

Source: KPMG's analysis of UBPRs for BOU.

The FDIC's Supervision of The Bank of Union

The FDIC, in coordination with the OSBD, provided ongoing supervisory oversight of BOU through regular on-site examinations, visitations, targeted reviews, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the bank's operations as early as 2008 and brought these risks to the attention of the institution's Board and management through examination reports, a visitation report, correspondence, and informal and formal enforcement actions. Such risks included inadequate Board and management oversight of the bank's complex structured credit products, lending activities (including loan administration and monitoring), and the decline in the loan portfolio. In retrospect, BOU's agricultural and C&I lending activities warranted an elevated level of scrutiny and a more proactive supervisory response to address the associated risks. The following sections detail BOU's supervisory history, the pursuit of enforcement actions, offsite monitoring activities, the supervisory response to key risks, the FDIC's compliance with PCA, and supervisory lessons learned.

Supervisory History

From June 2008 until BOU's closing in January 2014, the FDIC and OSBD conducted five on-site examinations and one visitation of BOU. Except for a relatively minor delay in starting the October 2012 FDIC examination, the frequency of these on-site examination activities was consistent with relevant statutory and regulatory requirements.[9] Table 4 summarizes key supervisory information pertaining to BOU's examinations and visitation.

Table 4: Examination History of BOU, 2008-2013

Examination Start Date	Examination or Visitation	Regulator(s)	Supervisory Ratings (UFIRS)	Informal or Formal Action Taken*
6/23/2008	Examination	OSBD	112122/2	None
1/11/2010	Examination	FDIC	223233/3	FDIC and OSBD MOU Effective 4/9/2010
8/9/2010	Visitation	Joint	No Rating Changes	MOU Still Outstanding
2/7/2011	Examination	Joint	222122/2	MOU Terminated Effective 4/20/2011
10/29/2012	Examination	FDIC	455433/4	OSBD Order Directing Restoration of Capital Effective 12/14/2012 FDIC and OSBD Consent Order Effective 6/12/2013
10/7/2013	Examination	Joint	555555/5	OSBD Consent Order Effective 11/21/2013 FDIC and OSBD Consent Order Still Outstanding

Source: KPMG's analysis of reports of examination and visitation reports and information in the FDIC's Virtual Supervisory Information on the Net (ViSION) for BOU.
* Informal actions often take the form of a Bank Board Resolution or MOU. Formal enforcement actions often take the form of a Cease and Desist Order, Consent Order, or PCA Directive.

Pursuit of Enforcement Actions

Based on the results of the January 2010 FDIC examination, the FDIC and OSBD entered into an MOU with BOU's Board that became effective on April 9, 2010. The purpose of the MOU was to address the concerns raised at the 2010 examination, including the bank's management and accounting treatment of its investments in complex structured credit products and weaknesses in the bank's credit administration and lending practices. Among other things, the MOU included provisions wherein BOU's Board agreed to:

- maintain a *Well Capitalized* position, including a minimum Tier 1 Leverage Capital Ratio of 8 percent;

[9] Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full-scope, on-site examinations of every state non-member bank at least once during every 12-month period. The regulation allows the annual examination interval to be extended to 18 months for certain small institutions (i.e., total assets of less than $500 million) if certain conditions are satisfied.

- review its objectives relative to asset growth with consideration of the bank's liquidity and capital positions;

- revise the Asset Liability Management Policy to address the deficiencies and recommendations in the January 2010 report of examination and implement procedures for monitoring the bank's sensitivity to market risk exposure;

- establish a plan that would improve the bank's liquidity posture and minimize dependency on volatile funding sources;

- amend the Investment Policy to address outstanding accounting guidance;

- increase the ALLL to the level recommended in the January 2010 report of examination and maintain the ALLL at a level that is sufficient for the risk exposure in the loan portfolio; and

- improve credit administration practices to address the deficiencies noted in the January 2010 report of examination.

In August 2010, the FDIC and OSBD conducted a joint visitation to assess the condition of BOU, management's response to the recommendations and contraventions of Statements of Policy noted at the January 2010 FDIC examination, and progress in addressing the provisions of the MOU. The visitation report stated that the overall condition of BOU was improving and that management was taking the necessary steps to achieve the goals of the MOU. However, the report also noted that some MOU provisions had not been fully addressed, including the provision related to credit administration practices and examination concerns on lending policy practices involving loan extensions and deferrals, the credit grading system, and concentration monitoring.

The February 2011 report of examination stated that BOU's overall condition reflected significant improvement and was satisfactory. In addition, BOU was found to be in substantial compliance with the MOU, although the bank had not fully addressed its credit administration weaknesses. Based on the results of the examination, the MOU was terminated effective April 20, 2011.

The October 2012 report of examination identified significant financial deterioration and the OSBD issued a formal Order against BOU on December 14, 2012. Among other things, the Order required BOU to charge-off all losses identified during the examination and increase equity capital in the amount of $40 million by December 31, 2012. The Order also imposed certain restrictions on extensions of credit greater than $25,000. The FDIC and OSBD also issued a Consent Order based on the results of the October 2012 FDIC examination. The Consent Order, which became effective on June 12, 2013 and remained in effect until the bank was closed in January 2014, required BOU's Board to (among other things):

- submit and adopt a written Capital Plan, a plan reducing classified assets, and a plan to reduce and collect delinquent loans;
- charge off or collect assets classified as loss;
- restrict advances to criticized borrowers;
- submit a written policy on extensions of credit, including restrictions on overdrafts exceeding $5,000 (unless reviewed and approved by the Board or loan committee);
- conduct an annual review of the loan policy by the Board and submit to the regulators for review any changes made to the loan policy;
- establish a loan review committee to periodically review the bank's loan portfolio and identify and categorize problem credits;
- correct deficiencies with loans listed as Special Mention and correct technical exceptions noted during the October 2012 FDIC examination;
- implement a system of monitoring and correcting loan documentation exceptions;
- restrict asset growth to no more than 5 percent during any consecutive 6-month period (unless otherwise approved by regulators);
- increase Board participation in the affairs of the bank;
- assess staffing needs and retain qualified management; and
- refrain from entering into new lines of business.

During the October 2013 joint examination, examiners determined that BOU had incurred significant loan losses and engaged in unsafe and unsound banking practices. As a result, the Oklahoma State Banking Commissioner issued an Order to Cease and Desist Unsafe and Unsound Banking Practices and to Restore Capital on November 21, 2013. Examiners also determined during the examination that BOU had not complied with many provisions of the June 2013 Consent Order.

Offsite Monitoring

The FDIC has established an offsite review program intended to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately.[10] Under the program, offsite reviews are performed by FDIC case managers each quarter for banks that appear on the Offsite Review List (ORL). For the 5-year period ended December 31, 2013, BOU appeared on the ORL four times—in September and December 2009, December 2011, and March 2012.

Both the December 2011 and March 2012 reviews were triggered by rapid asset growth. Specifically, BOU experienced total asset growth of 12 percent for the 1-year periods ending December 2011 and March 2012. Loan growth increases during those periods were 17 percent and 19 percent, respectively. The December 2011 review noted that the bank's growth was primarily in commercial loans funded by an increase in core deposits. The review did not indicate a significant change in the bank's condition. RMS contacted BOU when it was flagged again for rapid asset growth in March 2012. Bank management indicated that the rapid growth was due to an oil and gas boom in the area that had added 2,000 to 3,000 local jobs and an influx of deposits and increased loan demand. According to RMS, the bank's explanation was both plausible and consistent with the experience of other banks in the local area. As a result, RMS concluded that there was no cause to change its normal supervisory program for BOU.

Supervisory Response to Key Risks

In the years preceding BOU's failure, the FDIC, in coordination with the OSBD, identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and recommendations. In addition, the FDIC and/or OSBD entered into an MOU with BOU's Board in April 2010, issued an Order Directing Restoration of Capital in December 2012, issued a Consent Order in June 2013, and issued another Consent Order in November 2013. A summary of supervisory activities related to BOU's key risks follows.

2008 Supervisory Activities

Examiners determined at the June 2008 OSBD examination that BOU's overall condition was satisfactory. However, the examination report noted concerns regarding BOU's then-recent purchase of complex CMOs totaling $5.2 million as of March 31, 2008. Examiners noted that the bank's funds management policies were insufficient to adequately manage the risk inherent in the investment securities. Examiners also cited an apparent contravention of both the 1996 *Joint Agency Policy Statement on Interest Rate Risk* and the 1998 *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*. With respect to asset quality, examiners noted that although the dollar amount of adversely classified assets had increased since the prior examination, management had a proven track record for handling asset quality issues in a satisfactory manner. Despite the concerns with the CMOs, examiners considered BOU to be in

[10] The program includes the use of various offsite monitoring tools to help assess the financial condition of institutions. The tools use statistical techniques and Call Report data to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions with rapid growth and/or a funding structure highly dependent on non-core funding sources.

satisfactory condition and management was noted to have generally provided adequate oversight.

2010 Supervisory Activities

Examiners determined at the January 2010 FDIC examination that BOU's overall condition was less than satisfactory. Board and management performance, risk management practices, controls over sensitivity to market risk, liquidity levels, and funds management practices were all in need of improvement. Of particular note, the bank had consummated a complex financial transaction wherein it sold its CMOs to a trust and (together with one of the bank's principal shareholders) purchased an equity interest in the trust. The bank's handling of the transaction resulted in repeat apparent contraventions of agency policy, along with accounting issues. Amendments to BOU's Call Reports dating back to December 2008 were required to address Other-Than-Temporary Impairment charges associated with the CMOs, inaccurate risk weightings for the securities, and an overstatement of accrued and capitalized interest.

Examiners identified several loans that were extended without full collection of interest due or that involved the capitalization of interest that was added to the balance of the note. Examiners strongly cautioned the Board against the liberal use of extensions, deferrals, and renewals as a permissive policy, adding that it could cloud the true performance and delinquency status of the loan portfolio. Examiners recommended improvements to the bank's lending policy and practices to address this matter. Examiners also recommended certain improvements to the bank's credit grading system and efforts to establish and monitor acceptable levels of concentrations. Examiners determined that the Adversely Classified Coverage Ratio had increased to 26 percent (compared to 8 percent at the prior examination) and noted a lack of current income information in certain loan files. Nevertheless, examiners determined that BOU's Asset Quality remained satisfactory and that BOU's management was considered capable of overseeing the volume of criticized loans. Further, examiners noted that the bank's methodology for calculating the adequacy of the ALLL needed to be expanded to encompass economic and qualitative factors and that an additional provision of $1.5 million was needed to cover anticipated loan and lease losses.

While BOU's capital ratios continued to decline due to asset growth outstripping earnings retention, examiner concerns regarding capital adequacy were mitigated because of a $5 million capital injection provided by one of UCC's principal shareholders. Based on the results of the examination, the FDIC downgraded each CAMELS component rating and the composite rating from the prior examination. The FDIC, working in coordination with the OSBD, also proposed an MOU to BOU's Board that became effective in April 2010.

The FDIC and OSBD conducted a joint visitation in August 2010 to assess BOU's financial condition as well as its progress in addressing the recommendations in the January 2010 report of examination and the provisions of the MOU. The visitation report noted that the bank's overall condition was improving as a result of capital protection enhancements, strong earnings relative to peer, asset quality improvement and growth moderation, and a reduction in volatile liabilities. Examiners noted that management had acted on almost all of the recommendations in the January 2010 report of examination and the examiners were generally satisfied with the bank's progress in addressing the provisions of the MOU. However, examiner recommendations related to loan extensions and deferrals, the credit grading system, and concentration monitoring efforts had not been addressed.

2011 Supervisory Activities

The February 2011 joint examination focused primarily on BOU's management and accounting treatment for its structured credit products and the related impact on the bank's sensitivity to market risk. The examination also focused on management's progress in addressing the provisions of the MOU and assessing asset quality. Examiners determined that BOU's overall condition had improved significantly and was satisfactory. Examiners also noted that management's responses to regulatory concerns had been prompt and BOU was in substantial compliance with the MOU, although several provisions had not been fully addressed, including the credit administration issues. Although the bank's Loan Administration Department had been strengthened by the addition of new employees, prior concerns and recommendations related to loan concentration monitoring and extensions, deferrals, and renewals had not been addressed. In the overall context of the examination findings, examiners decided to upgrade BOU's composite and component ratings (except for the Capital and Asset Quality component ratings, which remained at a "2") and terminate the MOU effective April 20, 2011.

Examiners noted that BOU's independent loan review process was not adequate for the size of the loan portfolio and classified 15 loans that had not been internally classified by management. While the bank's written guidance for loan reviews appeared reasonable, it was not being implemented, and examiners recommended that management strengthen the loan review process, thoroughly document such reviews, and maintain strong credit standards given the growth in the loan portfolio. Adversely classified assets had increased to $9.3 million since the prior examination, although examiners noted that the increase was somewhat mitigated by the $5 million capital injection from one of UCC's principal shareholders.

While examiners commended management for its efforts in achieving the goals of the MOU, examiners noted that continued improvement was needed in BOU's processes for measuring, monitoring, and controlling risk. The report of examination identified a number of *Matters Requiring Board Attention* that included (among other things) the need to:

- improve loan administration practices with regard to extensions, deferrals, and renewals;

- expand written guidelines to address specific limitations and monitoring requirements for concentrations; and

- establish and implement written guidance for determining compensation arrangements for bank officers.

2012 Supervisory Activities

Following BOU's ratings upgrade at the February 2011 joint examination, the bank's examination interval increased from 12 to 18 months. As a result, the next on-site examination of BOU commenced in October 2012. During that FDIC examination, examiners determined that BOU had experienced significant financial deterioration stemming from aggressive lending in the livestock and trucking industries coupled with a lack of Board and management oversight and supervision of the lending function. Although examiners had repeatedly raised concerns to management about its liberal loan renewals and practice of capitalizing interest, these risks had not been addressed and concealed performance weaknesses in the loan portfolio. Consequently, reported levels of past due and nonaccrual loans had been understated and the volume of adversely classified assets increased 1,083 percent from the prior examination to $110 million. It was also evident that the bank's efforts to address the loan review concerns from the prior examination were inadequate, as 96 percent of the adversely classified loans were not internally classified by management and a provision of $49.4 million was required to restore the ALLL to an acceptable level.

Examiners cited numerous concerns and weaknesses relative to the supervision of the lending function, management of large asset concentrations, and controls pertaining to overdrafts. Examiners noted that the Board had allowed the CEO to "exercise a dominant level of control over the lending function" after the departure of three senior lending officials in 2012. Notably, the CEO had originated $114.2 million (or 73 percent) of the loans examiners criticized during the examination. Examiners attributed the lack of oversight of the lending function as a contributing factor to the apparent violations of law and contraventions of regulatory Statements of Policy identified during the examination.

In conjunction with the October 2012 FDIC examination, the FDIC conducted a targeted review to determine the reasons why the three senior lending officials departed the bank in a short period of time and whether there was any breach of fiduciary duties by bank officers or directors in connection with certain loans. While the review did not uncover any breach of fiduciary duties by the bank officers or directors, it did find that the bank engaged in unsafe and unsound practices with respect to the manner in which the loan portfolio was managed. Perhaps most notably, the FDIC's review found significant concerns in a $56 million borrower concentration described earlier in this report. Specifically, the review indicated that:

- the bank's collateral position was questionable. For example, lien searches indicated that feedlots were in a senior position to the bank and that BOU's lien may have been subordinate to another bank;

- proceeds on certain loans to purchase cattle may have been used to also fund commodity purchases of cattle, wheat, oil, and gas futures;

- credit files lacked independent cattle inspections and current financial statements needed to assess the creditworthiness of the borrowers; and

- the CEO frequently granted new loans, renewals, and extensions without Board approval.

Overall, the review indicated that the collateral, consisting primarily of cattle, was unverifiable based upon the information available to examiners and, therefore, the position of the bank in its collateral was suspect as to whether the bank had a perfected interest in the cattle and where the cattle were located. The review further indicated that the net worth of the borrowers provided no secondary source of repayment.

Based on the initial results of the 2012 FDIC examination, the Oklahoma State Banking Commissioner issued an Order Directing Restoration of Capital against BOU on December 14, 2012, requiring, among other things, that the bank increase equity capital in the amount of $40 million. On December 27, 2012, one of UCC's principal shareholders invested the required capital. Notwithstanding the capital injection, examiners considered the bank's capital level to be inadequate given its risk profile. As a result of the supervisory concerns identified during the examination, examiners downgraded BOU's composite rating to a "4" and lowered the Asset Quality and Management components to a "5."

2013 Supervisory Activities

Following the October 2012 examination, the FDIC continued to correspond with the bank, periodically monitored bank documentation and financial performance reports, and conducted two meetings with the full Board to discuss the examination findings. In a letter dated April 3, 2013, the FDIC notified BOU that the bank was considered to be in a "troubled condition." Such a designation involves restrictions and limitations on certain business activities. In the same letter, the FDIC communicated its intent to pursue a formal enforcement action to address the safety and soundness concerns identified during the examination. The Consent Order, signed by the FDIC and the Oklahoma State Banking Commissioner, became effective on June 12, 2013. The FDIC and OSBD had tentatively scheduled an on-site presence at the bank in August 2013. However, RMS officials informed us that such activity was postponed until early October 2013 while the bank attempted (unsuccessfully) to sell a large volume of loans during the summer of 2013.

The FDIC and OSBD performed a joint examination in October 2013 to assess BOU's financial condition and the bank's compliance with the Consent Order. Examiners noted that BOU's condition was critically deficient and that capital had declined significantly since the previous examination. Without an immediate infusion of capital, the viability of the bank was threatened. Asset quality continued its sharp deterioration since the previous examination and losses on loans and other assets were critically excessive. Examiners determined that management's overall performance was highly unsatisfactory. In addition, earnings continued to be severely impacted by poor asset quality and significant loss provisions required to appropriately fund the ALLL.

Examiners noted that management had been reluctant to recognize deterioration or loss in a timely manner—especially in livestock and trucking loans. It was further noted that management's efforts to address numerous provisions of the Consent Order were insufficient or ineffective. Consequently, examiners assigned a "5" rating for all CAMELS components and the composite rating. Among other things, the report of examination noted:

- apparent violations of law, including apparent repeat violations of legal lending limits and FDIC Rules and Regulations, and contraventions of Statements of Policy;

- a lack of Board supervision and control over the lending function, aggressive lending, and excessive credit concentration risks;

- loan losses totaling $118.2 million, representing 259 percent of capital and reserves;

- seven individual credit concentrations totaling $91.5 million (or 28 percent of total assets), of which $64.1 million was considered loss and $16.7 million substandard;

- a past due and nonaccrual loan ratio of 53.83 percent, which had increased from a modest 1.99 percent at the prior examination; this substantial increase was attributed to the Consent Order's restriction on management's liberal use of credit extensions, deferrals, renewals, and overdrafts—all of which had the effect of clouding the true performance of the loan portfolio;

- repeat credit administration weaknesses, including an inadequate loan review and loan grading system, excessive loan documentation deficiencies, and a lack of appropriate credit memoranda in loan files;

- dominant control by the CEO over the lending function; and

- a required $96.9 million provision to restore the ALLL to a minimally acceptable level.

Concurrent with the October 2013 joint examination, RMS performed another targeted review of BOU's lending activities that focused on the bank's large borrowing relationship (described earlier in this report). In addition to identifying many of the deficiencies and weaknesses described in the report of examination, the targeted review found that BOU did not apply sound lending practices with respect to the borrowing relationship, such as properly securing and inspecting collateral.

Implementation of PCA

Section 38 of the FDI Act, *Prompt Corrective Action*, establishes a framework of mandatory and discretionary supervisory actions pertaining to all insured depository institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions" as an institution's capital level declines. The purpose of section 38 is to resolve the 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 to be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans (CRP) and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor institution compliance with CRPs, 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 BOU, the FDIC properly implemented the applicable PCA provisions of section 38. BOU was considered *Well Capitalized* or *Adequately Capitalized* for PCA purposes until October 2013, at which time the institution fell to and remained *Critically Undercapitalized*. Table 5 summarizes BOU's capital ratios relative to the PCA thresholds for *Well Capitalized* institutions during examinations and at other key points in time. A chronological description of the changes in the bank's capital categories and the FDIC's implementation of PCA follows the table.

Table 5: BOU's Capital Ratios

Examination or Event Date	Total Risk-Based	Tier 1 Risk-Based	Leverage	PCA Capital Category
Well Capitalized Threshold	**≥10%**	**≥6%**	**≥5%**	
6/23/2008 Examination	13.74	13.26	10.47	*Well Capitalized*
1/11/2010 Examination	9.50	8.56	7.59	*Adequately Capitalized*
8/9/2010 Visitation	12.54	-*	9.79	*Well Capitalized*
2/7/2011 Examination	11.69	10.70	9.2	*Well Capitalized*
10/29/2012 Examination	11.30	9.99	8.47	*Well Capitalized*
6/12/2013 Consent Order	-**	-**	-**	*Adequately Capitalized*
10/31/2013 PCA Notification***	1.77	0.88	0.60	*Critically Undercapitalized*
10/7/2013 Examination	-58.57	-58.57	-33.41	*Critically Undercapitalized*

Source: KPMG's Analysis of BOU examination reports and PCA activities.
* The visitation did not cite the bank's Tier 1 Risk-Based capital ratio.
** BOU became *Adequately Capitalized* because the Consent Order included a capital provision, not because of its capital levels at that time.
*** The PCA notification was based on September 30, 2013 Call Report data.

During the October 2012 FDIC examination, examiners identified large loan losses and an underfunded ALLL resulting in an examination-adjusted Capital Leverage ratio of negative 2.40 percent. As a result, the OSBD issued an order directing BOU to raise capital, and one of UCC's principal shareholders made a $40 million capital injection into the bank in December 2012. Although the bank was *Well Capitalized* based on the capital injection, the FDIC and OSBD pursued a Consent Order that contained (among other things) a capital provision. When the Consent Order became effective in June 2013, BOU could no longer be considered *Well Capitalized* for PCA purposes.[11]

In a letter dated October 31, 2013, the FDIC notified BOU's Board that the bank had fallen to *Critically Undercapitalized* based upon its September 30, 2013, Call Report filing and that the institution would be placed into receivership unless it was determined that a different action would better carry out the purposes of section 38. The FDIC further informed BOU's Board that the bank was subject to the mandatory requirements

[11] Section 325.103(b)(1)(iv) of the FDIC Rules and Regulations states that for an institution to be considered *Well Capitalized*, it must not be subject to any written agreement, order, capital directive, or prompt corrective action directive issued by the FDIC pursuant to section 8 of the FDI Act, International Lending Supervision Act of 1983 (ILSA), section 38 of the FDI Act, or any regulation thereunder, to meet and maintain a specific capital level for any capital measure.

of section 38 and should develop policies and procedures to ensure compliance. Other mandatory requirements applicable to BOU included, but were not limited to:

- the submission of a CRP to the FDIC;
- restrictions on asset growth, acquisitions, and new activities and branches; and
- restrictions on payments of dividends or making any other capital distributions, management fees, or executive compensation.

BOU requested, and the FDIC approved, an extension on the CRP submission deadline to December 18, 2013. Upon receipt and review of the CRP, the FDIC deemed the plan unacceptable and, given the rapid deterioration in the bank's capital condition, issued a PCA Directive on December 19, 2013. Among other things, the PCA Directive required BOU to take certain actions including, but not limited to:

- submitting an acceptable CRP on or before December 27, 2013;
- increasing capital to restore the bank to an *Adequately Capitalized* position;
- not extending credit for any highly-leveraged transactions;
- refraining from extending, directly or indirectly, any additional credit to or for the benefit of any borrower whose existing credit is classified Loss, Doubtful, Substandard, or Special Mention;
- refraining from paying excessive compensation or bonuses; and
- restricting the declaration or payment of cash dividends without the prior written approval of the FDIC.

In a letter to the FDIC dated December 27, 2013, BOU's Interim President/CEO informed the FDIC that the bank's management did not believe that it would be able to submit a CRP acceptable to the FDIC. In addition, the principal UCC shareholder who had previously provided capital support for the bank indicated that no further capital investments in BOU would be made. Other efforts to recapitalize the bank were unsuccessful. As a result, the OSBD closed BOU on January 24, 2014.

Supervisory Lessons Learned

BOU's practice of continually extending, deferring, and renewing its livestock loans warranted an elevated level of scrutiny because such credits are typically structured as short-term loans that are paid off when the underlying collateral (i.e., livestock) is liquidated. When the structure and purpose of such loans are not properly aligned and enforced, the ability of bank management to effectively monitor the loans and identify performance problems can become compromised. Such practices also increase the possibility that loan proceeds may be used for unintended purposes.

The February 2011 report of examination recommended that BOU improve its loan administration practices with respect to extensions, deferrals, and renewals, which were repeat recommendations from the January 2010 examination. In response, BOU's management informed the FDIC that it was taking various actions, such as modifying the bank's loan policy, briefing its loan officers about the concerns, and designating an officer to monitor compliance with the loan policy. However, BOU did not address those recommendations and continued its practice of extending, deferring, and renewing loans. In retrospect, it would have been prudent for the FDIC to have followed up with the bank to ensure these repeat concerns were promptly corrected. Further, a more comprehensive assessment of BOU's largest borrowing relationship—which primarily involved livestock loans—may have uncovered the bank's practice of using account overdrafts to keep the debt of certain borrowers within the relationship current. In addition, the report of examination was not critical of BOU's collateral inspections related to livestock loans. Our review of documentation in the examination working papers for certain livestock loans, which later resulted in large losses, found that the associated collateral documentation lacked relevant and detailed information and did not evidence preparation by an independent third party.

Based on the deficient and uncorrected lending practices cited at the October 2012 examination, the OSBD promptly issued an order that, among other things, resulted in a $40 million capital injection and significantly limited BOU's ability to extend new credit, helping to expose the degree to which borrowers of the bank, including its largest borrowing relationship, were unable to pay their debt. The regulators also raised concern about the independence and reliability of collateral inspections related to the bank's largest borrowing relationship. In response, BOU obtained a new inspection in December 2012 covering much of the collateral supporting the relationship's debt, although examiners later determined that the inspection's independence and reliability were questionable. These actions, however, could not reverse the substantial losses already embedded in the bank's loan portfolio, which led to the bank's failure.

Under the FDIC's forward-looking approach to bank supervision, which was re-emphasized to the FDIC examination workforce in 2010, banks with weak risk management practices are subject to increased supervisory analysis and a proactive supervisory response when risks are not properly managed. With respect to BOU's agricultural and C&I loans, including livestock loans, such a response would have been prudent and could have involved holding the Board and bank management to a stronger commitment to address the repeat weak lending practices identified during the February 2011 examination and more promptly following up to confirm that collateral inspections were adequate.

On July 16, 2014, the FDIC issued FIL-39-2014, entitled *Prudent Management of Agricultural Credits Through Economic Cycles*.[12] The FIL reminds FDIC-insured institutions that engage in agricultural lending to maintain sound underwriting standards, strong credit administration practices, and effective risk management strategies. With respect to the issues raised in this report, the FIL states (among other things) that:

- risk analysis should center on a borrower's cash flow and repayment capacity and not rely unduly on collateral values;
- credit analysis should assess the timing and level of projected cash flows over a reasonable period and ensure that cash flows match the purpose and terms of a loan;
- analysis of a borrower's overall financial status, including credit history and use of nonbank credit, is an important part of assessing a borrower's willingness and ability to repay their debts;
- lenders should analyze secondary repayment sources and collateral support levels;
- lenders should focus the credit analysis on a borrower's financial strength and repayment ability; and
- management should document all lien perfections; conduct timely, independent collateral inspections; and develop a process for monitoring collateral values to manage risk over the life of a loan.

When an institution fails to adequately implement these lending practices, as was the case with BOU, there is an increased risk to the institution and, ultimately, the DIF.

[12] This FIL rescinded and replaced FIL-85-2010, *Prudent Management of Agricultural Credit through Farming and Economic Cycles*, dated December 14, 2010.

Objectives, Scope, and Methodology

Objectives

The objectives of this MLR were to (1) determine the causes of BOU's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of BOU, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. We conducted this MLR as a performance audit from March 2014 to July 2014 in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of the audit included a review of BOU's financial condition, risk management controls and practices, and business activities from the time of the June 2008 OSBD examination until the bank's failure on January 24, 2014. The audit also included an evaluation of the regulatory supervision of the bank during the same time period.

To determine the causes of BOU's failure and the resulting material loss to the DIF, we reviewed relevant reports, correspondence, and other analyses prepared by RMS, DRR, and the OSBD. For example, we reviewed reports of examination and visitation reports, UBPRs, the FDIC's Board case addressing BOU's failure, and a supervisory history prepared by RMS. We also reviewed certain reports and analysis prepared by BOU or its contractors, including the *Report of the Study of the Management and Staffing of The Bank of Union and Proposed Management Plan*. In addition, we interviewed RMS officials in the Dallas Regional Office and Oklahoma City Field Office as well as OSBD officials to obtain their perspectives on the principal causes of BOU's failure. Further, we met with DRR officials in the Dallas Regional Office and reviewed selected loan files and bank records maintained by DRR.

To evaluate the FDIC's supervision of BOU, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act, we assessed whether the supervisory approach and actions taken with respect to BOU 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 BOU in the context of the issues that contributed to the bank's failure;

- identified and reviewed RMS policies and procedures, including the *Risk Management Manual of Examination Policies* and the *Formal and Informal*

Actions Procedures Manual, that were relevant to BOU and the supervisory actions taken with respect to the bank;

- analyzed reports of examination and visitation reports, as well as selected examination working papers, correspondence, and data maintained in ViSION, to identify the timing and nature of supervisory actions taken to address risks at the bank;

- reviewed selected loans files and related examination workpapers to determine if the loan files included adequate information on loan purpose, source of repayment, collateral and valuation, secondary support, payment terms, borrower financial information, lien perfections, reasons for modifications, and bank management approval, as well as the extent of RMS or OSBD review of the relationship during the scope period of the MLR;

- reviewed the FDIC's offsite monitoring activities to determine the extent to which they complied with FDIC policy and affected the supervisory approach taken for BOU;

- reviewed bank data and correspondence files maintained at the RMS Dallas Regional Office and Oklahoma City Field Office;

- interviewed FDIC officials who had supervisory responsibility for BOU, most notably officials in the RMS Dallas Regional Office and examiners in the Oklahoma City Field Office, to obtain clarification and context regarding key supervisory activities and determinations; and

- contacted OSBD officials to obtain their perspectives on the supervision of BOU.

We obtained data from various FDIC systems, 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 hard-copy and electronic information provided by the FDIC OIG, RMS, and DRR as well as testimonial evidence provided during interviews. We did not perform specific audit procedures to assess the reliability of this information. However, we are aware that FDIC Circular 12000.1, *Cooperation with the Office of Inspector General*, dated September 28, 2007, requires that all FDIC employees, contractors, and subcontractors cooperate with the OIG in order for the OIG to carry out its statutory mandate. To that end, all employees, contractors, and subcontractors must:

(1) Provide authorized representatives of the OIG immediate and unrestricted access to all Corporation, receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, files, information systems, and other sources of information when requested during the course of their official duties.

(2) Provide authorized representatives of the OIG immediate and unrestricted access to any records or material available to any part of the FDIC.

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 section 337.12. The results of our compliance tests are discussed in this report, where appropriate. Additionally, we assessed the risk of fraud and abuse related to our audit objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

Consistent with the FDIC OIG's approach of considering the circumstances and lessons learned from individual bank failures in the broader context of other bank failures, our report contains no recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in MLRs, the FDIC OIG periodically communicates those matters to FDIC management and makes recommendations, as warranted.

We were provided with a memorandum issued by the OIG on May 1, 2009 that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to the failures of FDIC-supervised institutions, 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 specifically in response to the May 2009 memorandum and (2) identify trends and issues that have 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, *PCA*, and section 39, *Standards for Safety and Soundness*) in the banking crisis. The FDIC OIG also issued an evaluation report to 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 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.

Glossary of Key Terms

Term	Definition
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.
Adversely Classified Coverage Ratio	The Adversely Classified Items Coverage Ratio is a measure of the level of asset risk and the ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor quality assets and may also indicate less ability to absorb the consequences of bad loans. The ratio is calculated as a measure of Adversely Classified Items to Tier 1 Leverage Capital and ALLL.
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.
Call Report	Consolidated Reports of Condition and Income (also known as Call Reports) are reports that are required to be filed by each insured depository institution pursuant to the FDI Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Capitalized Interest	Unpaid accrued interest that is added to the outstanding principal loan balance.
Capital Restoration Plan (CRP)	Section 325.104(a)(1) of the FDIC Rules and Regulations requires a bank to file a written CRP with the appropriate FDIC regional director within 45 days of the date that the bank receives notice or is deemed to have notice that the bank is *Undercapitalized*, *Significantly Undercapitalized*, or *Critically Undercapitalized*, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period.

Term	Definition
Cease and Desist Order or Consent Order	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. A Cease and Desist Order may be terminated by the regulators when they have determined that the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms. A Consent Order is a Cease and Desist Order that has been stipulated to by the bank's Board.
Collateralized Mortgage Obligations (CMOs)	Sometimes referred to as structured credit products, CMOs are bonds that represent claims to specific cash flows from large pools of home mortgages. The streams of principal and interest payments on the mortgages are distributed to the different classes of CMO interests, known as tranches, according to a specific deal structure. Each tranche may have different principal balances, coupon rates, prepayment risks, and maturity dates (ranging from a few months to 20 years). CMOs are often highly sensitive to changes in interest rates and any resulting change in the rate at which homeowners sell their properties, refinance, or otherwise pre-pay their loans. Investors in these securities may not only be subject to this prepayment risk but also exposed to significant market and liquidity risks.
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, geographic region, or affiliated group. Collectively, these assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution. The FDIC Exam Manual defines concentrations as (1) an exposure to any industry, product line, or type of collateral representing more than 100 percent of Tier 1 Capital and (2) an exposure to an individual borrower or small interrelated group of individuals aggregating more than 25 percent of Tier 1 Capital.
Efficiency Ratio	A measure of total overhead expense expressed as a percentage of net interest income plus noninterest income. A low efficiency ratio is generally considered to be favorable.
Extension, Deferral, Renewal	<u>Extension</u>: Extending monthly payments on a closed-end loan and rolling back the maturity date by the number of months extended. The account is shown current upon granting the extension. If extension fees are assessed, they should be collected at the time of the extension and not added to the balance of the loan. <u>Deferral</u>: Deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity, of the loan. The account is shown current upon granting the deferral. <u>Renewal</u>: Underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms.

Term	Definition
Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to repay a loan. During underwriting, proper global cash flow analysis 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, current and complete operating statements of all related entities, and future economic conditions. 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.
Loan Production Office	Loan production offices are banking offices that take loan applications and arrange financing for corporations and small businesses, but they do not accept deposits. Loan applications are subject to approval by the lending institution.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, a material loss is defined as any estimated loss to the DIF in excess of $50 million for losses that occur on or after January 1, 2014.
Memorandum of Understanding (MOU)	An MOU 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	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.
Offsite Review List (ORL)	The ORL identifies institutions warranting heightened supervisory oversight. Since the offsite review program is intended to identify potential emerging problems, the ORL includes only those institutions with a composite rating of a "1" or "2."
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify a bank's 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 based on certain financial ratios and other factors. Regional management is responsible for implementing procedures to ensure that offsite review findings are factored into examination schedules and other supervisory activities.

Term	Definition
Peer Group	For financial analysis and comparison purposes, 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 United States Code, 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*. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Repayment Program	An agreement between a lender and borrower that gives the borrower a period of time to bring a delinquent loan current by making regular monthly payments plus an additional amount to repay the delinquency. The program may include renegotiated terms that generally provide some measure of relief to the borrower in terms of reducing the debt-servicing burden through accommodative measures provided by the lender, such as extending the term of the loan or rescheduling repayments.
Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based capital framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2). Part 325 Appendix A—*Statement of Policy on Risk-Based Capital*—defines the FDIC's risk-based capital rules. Appendix A states that an institution's balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to broad risk categories according to the obligor, or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the risk categories are added together, and this sum is the risk-weighted assets total that, as adjusted, comprises the denominator of the risk-based capital ratio. The institution's qualifying total capital base is the numerator of the ratio.

Term	Definition
Special Mention	A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in the 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.
Tier 1 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).
Uniform Bank Performance Report (UBPR)	The UBPR is an analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.
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: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Each component, and an overall composite, is assigned a rating of "1" through "5," with "1" having the least regulatory concern and "5" having the greatest concern.
Virtual Supervisory Information on the Net (ViSION)	An FDIC information system that provides access to a broad range of information related to insured financial institutions in support of the Corporation's insurance and supervision programs. RMS personnel use the system to perform supervisory-related functions, such as tracking applications, accessing examination information, and monitoring enforcement actions. Analysts in the Division of Insurance and Research also rely on information in ViSION to perform insurance-related functions, such as analyzing trends in the banking industry and calculating deposit insurance assessment rates for financial institutions.

Acronyms

ALLL	Allowance for Loan and Lease Losses
BOU	The Bank of Union
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CEO	Chief Executive Officer
C&I	Commercial and Industrial
CMO	Collateralized Mortgage Obligation
CRP	Capital Restoration Plan
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
MLR	Material Loss Review
MOU	Memorandum of Understanding
OIG	Office of Inspector General
ORL	Offsite Review List
OSBD	Oklahoma State Banking Department
PCA	Prompt Corrective Action
RMS	Division of Risk Management Supervision
UBPR	Uniform Bank Performance Report
UCC	Union City Corporation
UFIRS	Uniform Financial Institutions Rating System
ViSION	Virtual Supervisory Information on the Net

Part II

Corporation Comments and OIG Evaluation

Corporation Comments and OIG Evaluation

Subsequent to the issuance of KPMG's draft report, RMS and OSBD officials provided additional information for our consideration, and KPMG revised its report to reflect this information, as appropriate. In addition, the Director, RMS, provided a written response, dated September 5, 2014, to a draft of this report. That response is provided in its entirety on pages II-2 and II-3 of this report.

In the response, the Director reiterated the causes of BOU's failure and the supervisory activities described in the report. The Director also agreed that, in retrospect, it would have been prudent to have followed up with the bank after the February 2011 joint examination to ensure that repeated concerns relative to loan extensions, deferrals, and renewals were properly corrected. In addition, the Director referenced guidance that was issued to FDIC-supervised institutions and examiners in 2010 and 2014 addressing prudent management practices for agricultural credits and described past and future examiner training initiatives focused on the evaluation of bank risk management practices.

FDIC

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

September 5, 2014

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 The Bank of Union, El Reno, Oklahoma (Assignment No. 2014)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of The Bank of Union, El Reno, Oklahoma, which failed on January 24, 2014. This memorandum is the response of the Division of Risk Management Supervision to the OIG's Draft Report (Report) received on August 5, 2014.

The Bank of Union (BOU) failed primarily because the Board and management did not effectively manage the risks associated with the aggressive growth and concentrations in commercial and industrial loans and agricultural loans, particularly in the livestock and livestock trucking industries. The Board did not provide sufficient oversight of the lending function, did not adopt adequate internal controls, and placed over-reliance upon the CEO, who exercised significant control over lending decisions. BOU also had a large and complex borrowing relationship that was not adequately managed, causing significant losses.

The Report covers the period 2008 through failure. During that period, the FDIC and the Oklahoma State Banking Department conducted five onsite examinations, one onsite visitation, and several offsite monitoring analyses. We agree with the OIG's observation that, in retrospect, it would have been prudent for the FDIC to have followed up with the bank after the 2011 examination to ensure that repeated concerns relative to extensions, deferrals, and renewals were promptly corrected. More particularly, in retrospect, it would have been prudent to verify through an interim onsite visitation, rather than just through correspondence, the corrective actions described by bank management as being undertaken because they were not ultimately executed. Further, three senior lenders departed the institution during 2012, leaving the CEO with sole control over the lending function. Despite a $40 million capital injection, inappropriate lending practices resulted in loan losses that depleted earnings and eroded capital.

Lack of attention to borrower cash flow was paramount among the deficiencies in BOU's credit administration program. The importance of borrower cash flow was emphasized in Financial Institution Letter (FIL) 85-2010 dated December 14, 2010 and titled Prudent Management of Agricultural Credit through Farming and Economic Cycles and re-emphasized with the issuance of FIL-39-2014 on July 16, 2014, Prudent Management of Agricultural Credits through Economic Cycles. The updated FIL also encourages financial institutions to work constructively with borrowers to strengthen the credit and mitigate loss. To enhance our supervision of institutions such as BOU, FDIC conducted examiner training initiatives emphasizing the evaluation of bank management's risk management practices in early 2010 and mid-2011, with additional training planned for later this year and throughout 2015. Lastly, the FDIC is also re-emphasizing to examiners the importance of evaluating management's supervision of significant concentrations of credit, such as those exhibited by BOU, and its implication to the financial health of the bank.

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