



## FDIC Examinations of Government-Guaranteed Loans

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May 2023

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Evaluation Report  
**Audits, Evaluations, and Cyber**

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## NOTICE

Pursuant to Pub. L. 117-263, section 5274, non-governmental organizations and business entities identified in this report have the opportunity to submit a written response for the purpose of clarifying or providing additional context to any specific reference. Comments must be submitted to [comments@fdicoig.gov](mailto:comments@fdicoig.gov) within 30 days of the report publication date as reflected on our public website. Any comments will be appended to this report and posted on our public website. We request that submissions be Section 508 compliant and free from any proprietary or otherwise sensitive information.

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## Executive Summary

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### FDIC Examinations of Government-Guaranteed Loans

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The Federal Deposit Insurance Corporation (FDIC) insures approximately \$10 trillion in deposits at 4,755 commercial banks, savings institutions, and domestic branches of foreign banks (as of September 30, 2022). Pursuant to its authorities under the Federal Deposit Insurance (FDI) Act, the FDIC serves as the primary Federal regulator for approximately 3,100 financial institutions (banks).

Federal agencies administer several Government-guaranteed loan programs to assist individuals and businesses with, among other things, buying homes, financing agricultural production, financing businesses, and purchasing equipment. These programs promote lending to rural and underserved communities and to borrowers with collateral weaknesses or that lack adequate credit history. Private lenders, such as banks insured and supervised by the FDIC, originate Government-guaranteed loans on the Federal agencies' behalf.

In Fiscal Year (FY) 2021, more than \$1 trillion was disbursed in Government-guaranteed loans by lenders on behalf of the U.S. Federal Housing Administration, U.S. Department of Veterans Affairs, U.S. Small Business Administration and U.S. Department of Agriculture. This figure grew by more than 154 percent since FY 2019 (from \$433 billion). The lenders disbursed nearly \$3 trillion in Government-guaranteed loans during this time. FDIC-supervised banks participate in these programs, originating billions of dollars in Government-guaranteed loans.

Without proper due diligence and supervision, Government-guaranteed loan programs can present substantial risks to banks. If a bank engages in Government-guaranteed loan programs without fully understanding or conforming to program requirements, their participation introduces risks to both the financial institution and to consumers, including operational risk, compliance risk, reputational risk, and strategic risk.

Banks may also subject themselves to increased fraud risk through Government-guaranteed loan programs. For example, there has been an estimated \$64.2 billion in fraud in the recent Paycheck Protection Program (PPP). These risks, if left unmitigated, can impact the safety and soundness of the bank, leading to deterioration or failure. In turn, this could result in increased risk or loss to the FDIC's Deposit Insurance Fund.

Our evaluation objective was to determine the effectiveness of the FDIC's examinations in identifying and addressing risks related to Government-guaranteed loans for banks that participate in Government-guaranteed loan programs.

## Results

FDIC bank examinations were not always effective in identifying and addressing risks related to Government-guaranteed loans. We determined that the:

- FDIC's guidance did not adequately address risks present in Government-guaranteed loan programs;
- FDIC could improve its supervision of bank activities in Government-guaranteed loan programs, including the PPP;
- FDIC's guidance differed from that of other Federal bank regulators;
- FDIC did not provide adequate training to examination personnel on Government-guaranteed lending programs;
- FDIC did not maintain adequate data to identify, monitor, and research bank participation in Government-guaranteed loan programs; and
- FDIC did not effectively share information externally and internally to enhance risk oversight of banks that participated in Government-guaranteed loan programs.

In addition, the FDIC's examination guidance did not provide clear instructions on the retention of examination workpapers.

## Recommendations

We made 19 recommendations to improve the FDIC's supervision of banks that participate in Government-guaranteed loan programs. We recommended that the FDIC develop and implement guidance on the risks, treatment, and identification of Government-guaranteed loans to promote consistency within the FDIC and with other Federal bank regulators; train FDIC personnel on the requirements and risks of Government-guaranteed loan programs; obtain improved data on Government-guaranteed lending activities; develop and implement guidance to facilitate information sharing with Federal agencies and examination staff to enhance risk oversight; and develop and implement updated guidance on the retention of supervisory business records.

The FDIC concurred with 13 recommendations and partially concurred with the remaining 6 recommendations, offering acceptable alternative actions. The FDIC plans to complete all corrective actions by March 31, 2024.

# Contents

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<b>Background</b> .....	<b>4</b>
Safety and Soundness Examinations.....	5
Consumer Compliance Examinations .....	5
Supervisory Actions.....	6
Significance of Government-Guaranteed Loan Program Lending .....	6
Risks of Government-Guaranteed Loan Program Lending.....	8
Fraud Risk.....	9
<b>Evaluation Results</b> .....	<b>12</b>
FDIC Guidance Did Not Adequately Address Risks in Government-Guaranteed Loan Programs .....	13
Guidance on Risks of Government-Guaranteed Loan Programs to Banks.....	14
Guidance on Loan Classification, Assessment of Off-Balance Sheet Risk, Concentration Risk, and Monitoring Specific to Government-Guaranteed Loans.....	18
The FDIC Could Improve Its Supervision of Bank Activities in Government-Guaranteed Loan Programs .....	21
Requests for Government-Guaranteed Loan Information During Examination Planning....	22
Assessment of Government-Guaranteed Loans Against Program Requirements .....	23
Classification of Government-Guaranteed Loans .....	25
Assessment of Off-Balance Sheet Risk for Government-Guaranteed Loans.....	26
Assessment of Government-Guaranteed Loans for Concentration Risk.....	28
The FDIC Did Not Adequately Supervise Risks of the Paycheck Protection Program for Certain Banks.....	31
FDIC Examination of Bank 1.....	34
FDIC Examination of Bank 4.....	35
FDIC Examinations of the Other Six Banks .....	36
The FDIC’s Guidance on Examination of Financial Institutions Differed from Other Federal Bank Regulators .....	38
Concentrations .....	39
Loan Classification .....	40
The FDIC Did Not Provide Adequate Training to Examination Staff on Government-Guaranteed Loan Programs .....	41
The FDIC Does Not Have Adequate Data to Identify, Monitor, and Research Bank Participation in Government-Guaranteed Loan Programs.....	43

# Contents

The FDIC Did Not Effectively Share Information on Government-Guaranteed Loan Programs Externally and Internally .....	46
External Information Sharing.....	46
Internal Information Sharing.....	50
The FDIC’s Examination Guidance Lacked Instructions on the Retention of Examination Workpapers .....	52
Conclusion.....	55
<b>FDIC COMMENTS AND OIG EVALUATION.....</b>	<b>55</b>

## Appendices

1. Objective, Scope, and Methodology	59
2. Acronyms and Abbreviations	62
3. Risks Related to Guaranteed Lending	64
4. Fraud Investigations – Government Guaranteed Loan Programs	65
5. Fraud Investigations – Paycheck Protection Program (PPP)	70
6. Bank Name Reference	75
7. FDIC Comments	76
8. Summary of the FDIC’s Corrective Actions	95

## Figure

Figure 1. PPP Timeline.....	32
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## Tables

Table 1. Federal Government-Guaranteed Loan Programs .....	7
Table 2. FDIC-Supervised Financial Institutions Reviewed by the OIG .....	22
(b) (8) .....	33
Table 4. FDIC-Supervised Financial Institutions' Participation in (b) (8) Government-Guaranteed Loan Program.....	45



**May 10, 2023**

**Subject** *FDIC Examinations of Government-Guaranteed Loans*

The Federal Deposit Insurance Corporation (FDIC) is responsible for carrying out a supervision program to promote safe and sound operations at financial institutions, protect consumers' rights, and promote community investment initiatives.<sup>1</sup> The FDIC insures approximately \$10 trillion in deposits at 4,755 commercial banks, savings institutions, and domestic branches of foreign banks (as of September 30, 2022).<sup>2</sup> Additionally, pursuant to its authorities under the Federal Deposit Insurance Act (FDI Act),<sup>3</sup> the FDIC serves as the primary Federal regulator for approximately 3,100 financial institutions.<sup>4</sup>

Federal agencies<sup>5</sup> administer several Government-guaranteed loan programs to assist individuals and businesses with, among other things, buying homes, financing agricultural production, acquiring businesses, and purchasing equipment. Between FY 2019 and FY 2021, lenders disbursed nearly \$3 trillion in Government-guaranteed loans to borrowers on behalf of four of the most prevalent agencies that administer Government-guaranteed loan programs.<sup>6</sup> These programs promote lending to rural and underserved communities and to borrowers that lack a history of established credit or that have collateral weaknesses. For example, the U.S. Department of Agriculture administers the Business and Industry Guaranteed Loan Program that specifically targets rural businesses by providing loan guarantees to banks, thus encouraging lending. The intent of the program is to save and create jobs in rural America.

Financial institutions insured and supervised by the FDIC originate Government-guaranteed loans with the Federal agencies' providing a guarantee for repayment to the bank in the event of default. When financial institutions participate in Government-guaranteed loan programs with the appropriate level of due diligence, these programs may serve as an avenue to realize earnings and mitigate credit risk, and as an opportunity to expand their loan portfolios.

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<sup>1</sup> 12 U.S.C. § 2901 et seq. (2022). The Community Reinvestment Act requires the FDIC to assess an institution's record of helping to meet the credit needs of the local communities in which the institution is chartered.

<sup>2</sup> FDIC, *Quarterly Banking Profile* (Third Quarter 2022).

<sup>3</sup> 12 U.S.C. §§ 1811-1835a (2022).

<sup>4</sup> For the purposes of the report, a financial institution represents an FDIC-insured depository institution. The word bank is used interchangeably with financial institution throughout this report.

<sup>5</sup> These agencies include, but are not limited to, the U.S. Department of Agriculture, the U.S. Small Business Administration (SBA), the Department of Housing and Urban Development, and the U.S. Department of Veterans Affairs.

<sup>6</sup> See Table 1 for additional details.

However, these Government-guaranteed loan programs are not without risk to financial institutions. When financial institutions fail to materially comply with Government-guaranteed loan program requirements in the areas of loan underwriting, closing, and servicing, the Federal agencies guarantying the loans can be released from their obligations.<sup>7</sup> If a financial institution engages in Government-guaranteed loan programs without fully understanding or complying with program requirements, their participation can introduce risks to both the financial institution and to consumers.<sup>8</sup> These risks include, among others, the following:

- **Operational risk:** A financial institution that does not have the requisite knowledge and familiarity of the workings of a Government-guaranteed loan program may realize losses due to its inability to perform within the Government-guaranteed loan program requirements.
- **Compliance risk:**<sup>9</sup> A financial institution that fails to comply with the Government-guaranteed loan program requirements, resulting in loss to the bank or consumers, could face civil money penalties or restitution.<sup>10</sup>
- **Liquidity Risk:** Financial institutions can sell Government-guaranteed loans in the secondary market at a premium, which increases liquidity for the institution. When a financial institution relies on selling Government-guaranteed loans for liquidity, an economic downturn could reduce the market participation, resulting in a negative impact to the bank's liquidity.
- **Reputation risk:** Banks that mishandle Government-guaranteed loan programs, violate program requirements, or engage in fraudulent acts may experience reduced liquidity or revenue due to customers removing deposits and seeking other sources to obtain financing as a result of the bank's poor reputation and costly litigation.
- **Strategic risk:** A financial institution that makes a strategic decision to concentrate on originating Government-guaranteed loans may realize reduced revenue, resulting in operating losses, if a Federal agency suspends its ability to originate Government-guaranteed loans.

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<sup>7</sup> This situation generally occurs after a financial institution or secondary market holder requests the administering agency to honor the guaranty. The underwriting phase of a loan application includes, among other things, determining the borrower's capacity to repay. Closing refers to the execution of the loan documents and disbursement of loan proceeds. Servicing a loan occurs after closing and includes, but is not limited to, processing loan payments and loan monitoring.

<sup>8</sup> OCC Bulletin 2021-34, *Small Business Administration Lending: Risk Management Principles* (August 2021).

<sup>9</sup> Operational risk may lead to compliance risk when inadequate staff knowledge results in a bank's noncompliance with Government-guaranteed loan program requirements.

<sup>10</sup> According to the FDIC *Formal and Information Enforcement Actions Manual*, civil money penalties are punitive and imposed to punish for misconduct involving violations, practices, or breaches, and to create, by example, a disincentive for similar misconduct by others. Further, restitution involves compensating the consumer (or other customer) for losses suffered as a result of violations.

- **Fraud Risk:** Financial institutions that administer Government-guaranteed loans may be subject to increased fraud risk. In addition to fraud risks introduced by bank insiders and customers, Government-guaranteed loan programs can introduce additional third parties into loan transactions. These third parties often have a financial incentive in the origination or servicing of the Government-guaranteed loans in the form of fee income. If these third parties do not act in good faith on behalf of the financial institution, the financial institution may realize increased losses, reputational harm, and legal impacts from the third parties' fraudulent actions, such as fraudulent loan approvals. See Appendix 4 for examples of Government-guaranteed loan fraud.

FDIC-supervised financial institutions participate in Government-guaranteed loan programs. (b) (8)

Within the last 5 years, approximately 1,281 of the 3,082 FDIC-supervised financial institutions (42 percent) approved loans totaling approximately \$66.1 billion under the (b) (8) loan program.<sup>12</sup>

In March 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)<sup>13</sup> created the Paycheck Protection Program (PPP) in order to provide financial relief and Government-guaranteed loans to small businesses adversely affected by the Coronavirus Disease 2019 (COVID-19) pandemic.<sup>14</sup> More than 2,600 FDIC-supervised financial institutions originated over 3 million PPP loans, totaling approximately \$270 billion.<sup>15</sup> Banks with less than \$10 billion in assets accounted for approximately 45 percent of PPP loans. In addition, these banks issued PPP loans at a rate disproportionate to their total assets, and disproportionate to their loan portfolios to small businesses before the pandemic.<sup>16</sup>

(b) (8)

<sup>12</sup> This is based on active FDIC-supervised financial institutions as of (b) (8). The approved loans include (b) (8) loans that were cancelled subsequent to approval or may be cancelled in the future. (b) (8)

Public Law No. 116-136, 134 Stat. 281 (March 27, 2020).

<sup>14</sup> The PPP is administered by the SBA. The SBA provides a 100 percent guaranty on PPP loans if lenders comply with program requirements.

<sup>15</sup> This amount excludes PPP loans that were cancelled or voluntarily terminated subsequent to original approval. The FDIC is not able to determine the full amount of PPP loans associated with FDIC-supervised financial institutions due to a lack of unique identifiers in the PPP loan data. Further, this amount reflects any changes made after origination.

<sup>16</sup> FDIC Center for Financial Research, *Bank Technology and the COVID-19 Pandemic* (February 2022).

If left unmitigated, the risks associated to hazardous activities in Government-guaranteed programs have actual consequences for banks. In October 2020, an FDIC-supervised financial institution failed<sup>17</sup> due in part to deficient Government-guaranteed loan administration and underwriting practices. The FDIC has also issued enforcement actions against other financial institutions due to deficiencies in their Government-guaranteed loan programs.

Our evaluation objective was to determine the effectiveness of the FDIC's examinations in identifying and addressing risks related to Government-guaranteed loans for banks that participate in Government-guaranteed loan programs. We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency *Quality Standards for Inspection and Evaluation*. Appendix 1 presents our evaluation objective, scope, and methodology.

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## BACKGROUND

The Division of Risk Management Supervision (RMS) and the Division of Depositor and Consumer Protection (DCP) conduct examinations to evaluate financial institutions as part of the FDIC supervision program. The FDIC supervision program is intended to help ensure that FDIC-supervised financial institutions operate in a safe and sound manner and comply with banking laws and regulations in providing financial services and engaging with consumers.

RMS conducts safety and soundness examinations of FDIC-supervised financial institutions to assess their overall financial condition, management practices and policies, and compliance with applicable laws and regulations. RMS also conducts specialty examinations of FDIC-supervised financial institutions, covering information technology (IT) and operations; Bank Secrecy Act (BSA)<sup>18</sup> and anti-money laundering (AML) compliance; and Trust Department<sup>19</sup> operations. The Large Bank Supervision Branch and each Region of RMS share the responsibility for the supervision and oversight of Large Insured Depository Institutions (LIDI). LIDIs are institutions with total assets greater than \$10 billion.

In addition, DCP conducts compliance examinations of FDIC-supervised financial institutions to assess compliance with Federal consumer protection laws and regulations.

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<sup>17</sup> OIG Report, [Failed Bank Review, Almena State Bank, Almena, Kansas](#) (FDIC OIG FBR-21-003) (March 2021).

<sup>18</sup> 31 U.S.C. §§ 5311-5336; 31 C.F.R. Part 1020 (2021). The BSA established anti-money laundering (AML) recordkeeping and reporting requirements for financial institutions. Federal bank regulators play a key role in helping to ensure that banks maintain adequate BSA/AML compliance programs to assist U.S. government agencies in detecting and preventing money laundering.

<sup>19</sup> According to the FDIC *RMS Manual of Examination Policies*, a bank's trust department acts in a fiduciary capacity when the assets it manages are not the bank's, but belong to and are for the benefit of others.

### Safety and Soundness Examinations

According to the FDIC RMS Manual of Examination Policies (FDIC RMS Manual), “onsite examinations help ensure the stability of the [insured depository institutions] by identifying undue risks and weak risk management practices.” RMS examinations of well-managed banks engaged in traditional, non-complex activities are risk-based, point-in-time examinations.<sup>20</sup> RMS also conducts continuous examinations<sup>21</sup> of institutions that are large<sup>22</sup> and complex.<sup>23</sup> Examiners may review Government-guaranteed loans during RMS examinations when assessing the bank’s asset quality.<sup>24</sup> RMS examination staff also perform visitations to assess changes in a financial institution’s risk profile, investigate unusual situations, and determine progress in correcting deficiencies. The FDIC implemented a Forward-Looking Supervisory initiative in 2011 as part of its risk-focused supervision program.<sup>25</sup> The goals of this supervisory approach are to identify and assess risk and weak risk management practices before they impact a financial institution’s financial condition.

### Consumer Compliance Examinations

To promote consumer protection, DCP compliance examinations focus on operational areas where compliance errors present the greatest potential risk of negative impact on bank customers, possibly resulting in consumer harm. During compliance examinations, examiners assess the quality of an FDIC-supervised institution’s compliance management system and review compliance with relevant laws and regulations.<sup>26</sup> FDIC consumer compliance examinations include gaining an understanding of the financial institution’s risk profile, assessing the quality of the institution’s compliance management system, and may also include transaction testing. The FDIC also conducts compliance visitations to review progress on corrective actions. The FDIC uses the Uniform Interagency Consumer Compliance

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<sup>20</sup> According to the *FDIC 2021 Annual Report*, RMS conducts point-in-time examinations every 12 to 18 months. The FDIC’s examinations may alternate with the appropriate State banking department under certain circumstances.

<sup>21</sup> According to the *FDIC 2021 Annual Report*, the continuous examinations include targeted reviews during an annual examination cycle. A dedicated FDIC team works jointly with the appropriate State banking department. The team prepares examination findings throughout the review cycle, upon completion of the targeted reviews of specific risk areas. The team prepares a roll-up report of examination at the end of the annual examination cycle. These are separate from any reviews conducted by the FDIC’s Division of Complex Institution Supervision and Resolution which were not covered by this evaluation.

<sup>22</sup> According to the *FDIC 2021 Annual Report*, large banks are generally those with total assets of \$10 billion or greater.

<sup>23</sup> According to the *FDIC RMS Manual*, to determine the bank’s complexity, examiners evaluate a combination of factors such as sophistication of an activity, the risk presented by the activity, and the volume of the activity. Examiners also consider the strategic initiatives of the institution.

<sup>24</sup> According to the *FDIC RMS Manual*, RMS examination staff assess and rate six financial and operational components - Capital adequacy, Asset quality, Management capabilities, Earnings sufficiency, Liquidity position, and Sensitivity to market risk - commonly referred to as CAMELS ratings. Examiners assign the component and composite ratings based on a numerical scale from 1 to 5, with 1 indicating the strongest performance and risk management practices. A 5 rating indicates the highest degree of supervisory concern.

<sup>25</sup> OIG Report, [Forward-Looking Supervision](#) (FDIC OIG EVAL-18-004) (August 2018).

<sup>26</sup> According to the *FDIC Consumer Compliance Examination Manual*, “[c]onsumer [h]arm is an actual or potential injury or loss to a consumer, whether such injury or loss is economically quantifiable (e.g., overcharge) or non-quantifiable (e.g., discouragement).”

Rating System to assign each financial institution a consumer compliance rating based on its evaluation of three factors: Board and management oversight; compliance program (policies and procedures, training, monitoring and/or audit, consumer complaint response); and violations of law and consumer harm.<sup>27</sup> The FDIC also uses a Community Reinvestment Act (CRA) rating system to evaluate a financial institution's performance under the CRA.<sup>28</sup>

### Supervisory Actions

The FDIC may issue a supervisory recommendation to a bank "...so that it can make appropriate changes in its practices, operations or financial condition and thereby avoid more formal remedies in the future, such as enforcement actions."<sup>29</sup> The FDIC may issue a Matter Requiring Board Attention (MRBA)<sup>30</sup> when it identifies a material issue or risk of significant importance requiring immediate board attention. Informal and formal enforcement actions against financial institutions may be issued by the FDIC in order to address weak operations, deteriorating financial conditions, or other actionable misconduct. Informal enforcement actions include Bank Board Resolutions and Memoranda of Understanding.<sup>31</sup> Formal enforcement actions include cease-and-desist and consent orders,<sup>32</sup> restitution,<sup>33</sup> and civil money penalties.<sup>34</sup>

### Significance of Government-Guaranteed Loan Program Lending

In Fiscal Year 2021, more than \$1 trillion was disbursed in Government-guaranteed loans by lenders on behalf of the U.S. Federal Housing Administration, the U.S. Department of Veterans Affairs, the U.S. Small Business Administration (SBA) and

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<sup>27</sup> According to the FDIC *Consumer Compliance Examination Manual*, the rating is based on a scale of 1 through 5, with 1 indicating the lowest degree of supervisory concern.

<sup>28</sup> 12 U.S.C. 2901. According to the FDIC *Consumer Compliance Examination Manual*, the CRA rating is based on several areas such as the geographic distribution of loans, borrowers' profiles, and community development activities. The FDIC assigns a CRA composite rating of outstanding, satisfactory, needs to improve, or substantial noncompliance.

<sup>29</sup> *FDIC RMS Manual*, Section 16.1, Report of Examination Instructions (December 2020).

<sup>30</sup> According to the FDIC, an MRBA requires the attention of the financial institution's Board of Directors.

<sup>31</sup> According to the FDIC *Formal and Informal Enforcement Actions Manual*, Bank Board Resolutions are informal commitments adopted by an institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A Memoranda of Understanding is an informal agreement between an institution and the FDIC, which is signed by both parties. A Memoranda of Understanding is designed to address and correct identified weaknesses in an institution's condition, or violations or unsafe or unsound practices.

<sup>32</sup> According to the *FDIC RMS Manual*, the purpose of a cease and desist order is to remedy unsafe or unsound practices or violations and to correct conditions resulting from such practices or violations. The FDIC issues a consent order when the financial institution agrees to the proposed enforcement actions. The institution executes a stipulation and consent to the issuance of a consent order (Consent Agreement) that is accepted by the FDIC.

<sup>33</sup> According to the FDIC *Formal and Informal Enforcement Actions Manual*, restitution is an equitable and remedial action because its purpose is to compensate the institution or consumer (or other customer) for losses suffered or to obtain the disgorgement of unjust enrichment as a result of misconduct involving violations or practices.

<sup>34</sup> According to the FDIC *Formal and Information Enforcement Actions Manual*, civil money penalties are punitive and imposed to punish for misconduct involving violations, practices, or breaches, and to create, by example, a disincentive for similar misconduct by others.

## FDIC Examinations of Government-Guaranteed Loans

the U.S. Department of Agriculture. This figure grew by more than 154 percent since FY 2019 (from \$433 billion). The lenders disbursed nearly \$3 trillion in Government-guaranteed loans during this time. See Table 1 below.<sup>35</sup>

**Table 1. Federal Government-Guaranteed Loan Programs**

Federal Agency	Loan Amount, Principal Disbursed Fiscal Year 2019	Loan Amount, Principal Disbursed Fiscal Year 2020	Loan Amount, Principal Disbursed Fiscal Year 2021
U.S. Federal Housing Administration	\$229,855,000,000	\$331,420,000,000	\$366,731,000,000
U.S. Department of Veterans Affairs	\$155,382,000,000	\$329,020,000,000	\$394,496,000,000
SBA	\$26,790,570,000	\$542,948,707,000*	\$308,925,787,000
U.S. Department of Agriculture	\$21,036,000,000	\$29,559,000,000	\$32,112,000,000
<b>Totals</b>	<b>\$433,063,570,000</b>	<b>\$1,232,947,707,000</b>	<b>\$1,102,264,787,000</b>

Source: OIG analysis of Federal Agency Annual Reports.

\*The increase is due to the CARES Act Paycheck Protection Program.

During this timeframe, FDIC-supervised financial institutions have significantly increased their participation in (b) (8)

<sup>36</sup> (b) (8)

Further, the approval amount of these loans increased from approximately \$12 billion in 2020 to approximately \$19.6 billion in 2021, an increase of 63 percent.

Financial Institutions' recent experience with the SBA's PPP has resulted in increased financial institution participation in Government-guaranteed loan programs.<sup>38</sup> In March 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)<sup>39</sup> created the PPP in order to provide financial relief and Government-guaranteed loans to small businesses adversely affected by the Coronavirus Disease 2019 (COVID-19) pandemic.<sup>40</sup> FDIC-supervised financial institutions

<sup>35</sup> This table does not include all Federal Government-guaranteed loan programs. We identified FDIC-supervised financial institutions participated in Government-guaranteed loan programs administered by the Federal Agencies included in the table.

<sup>36</sup> Loans made under the (b) (8)

(b) (8)

<sup>38</sup> American Banker, *PPP Boosts Banks' Interest in Other SBA Loan Programs* (February 2021).

<sup>39</sup> Public Law No. 116-136, 134 Stat. 281 (March 27, 2020).

<sup>40</sup> The PPP is administered by the SBA. The SBA provides a 100 percent guaranty on PPP loans if lenders comply with program requirements.

awarded PPP loans to borrowers<sup>41</sup> on behalf of the SBA. According to the SBA, more than 11 million PPP loans, totaling nearly \$800 billion, were approved by more than 5,400 lenders.<sup>42</sup>

More than 2,600 FDIC-supervised financial institutions originated over 3 million PPP loans, totaling approximately \$270 billion.<sup>43</sup> (b) (8)

This approval rate reflects a loan approval every 3 seconds. Due to the expedited development and delivery of the PPP program in combination with an increased reliance on borrower self-certifications,<sup>44</sup> fraud risk was elevated for the PPP. It appears relaxed program requirements made the PPP a target for fraud.

### Risks of Government-Guaranteed Loan Program Lending

Participation in Government-guaranteed loan programs introduces unique risks. For example, Government-guaranteed loan programs often have complex requirements and documentation standards that present compliance challenges for financial institutions.

If financial institutions do not exercise appropriate due diligence or comply with program requirements, they face exposure to, among others, additional credit risk, operational risk, compliance risk, liquidity risk, and strategic risk.

The Office of the Comptroller of the Currency (OCC) issued a bulletin in August 2021 highlighting the various risks associated with engaging in SBA guaranteed lending activities.<sup>45</sup> The OCC bulletin stated that “[t]he primary risks associated with SBA lending are credit, operational, compliance, liquidity, price, and strategic, with many of the risks interrelated.” See Appendix 3 regarding risks associated with SBA lending. Other Government-guaranteed loan programs share similar risk characteristics, such as unique program requirements, borrowers lacking traditional

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<sup>41</sup> According to the CARES Act, eligible borrowers are small business concerns, nonprofit organizations, veterans organizations, or tribal business concerns that employ not more than the greater of 500 employees or, if applicable, the size standard in number of employees established by the SBA for the industry in which the business concern, nonprofit organization, veterans organization, or tribal business concern operates. Eligible borrowers also include individuals who operate under a sole proprietorship or as an independent contractor, and self-employed individuals.

<sup>42</sup> SBA, *Paycheck Protection Program (PPP) Report* (Approvals through May 31, 2021).

<sup>43</sup> This amount excludes PPP loans that were cancelled or voluntarily terminated subsequent to original approval. We were unable to determine the full amount of PPP loans associated with FDIC-supervised institutions due to a lack of unique identifiers in the PPP loan data. Further, this amount reflects any changes made after origination.

<sup>44</sup> The Paycheck Protection Program Borrower Application Form required the authorized representative of the applicant to certify, amongst other things, that (1) the applicant was eligible to receive a loan under the programs rules, (2) all loan proceeds would be used for business-related purposes as specified in the application and consistent with the program rules, (3) the applicant was in operation on February 15, 2020, and (4) the applicant has not and will not receive another loan under the Paycheck Protection Program.

<sup>45</sup> OCC Bulletin 2021-34, *Small Business Administration Lending: Risk Management Principles* (August 2021).

credit or cash flow characteristics, financial institution responsibility for loan servicing and collateral liquidation, and the ability to sell the Government-guaranteed portion of the assets on the secondary market for a premium. For these reasons, it is critical that financial regulators consider the risks associated with Government-guaranteed loan programs in their supervisory oversight.

FDIC Reports of Examination (ROE) have acknowledged that lending in Government-guaranteed loan programs is complex and requires significant infrastructure to comply with underwriting and collection rules. The risks associated with Government-guaranteed loan programs have affected multiple FDIC-supervised financial institutions.

- Almena State Bank, a financial institution that failed in 2020, had an aggressive growth strategy that focused on originating large Government-guaranteed loans. However, the Board and bank management lacked the requisite skills and experience to ensure appropriate loan underwriting and credit administration.<sup>46</sup> These deficiencies resulted in increased credit risk, operational risk, compliance risk, and strategic risk for the bank, ultimately contributing to its failure.
- Community South Bank, had an aggressive growth and funding strategy related to Government-guaranteed lending. This strategy led to the bank's failure in 2013, resulting in an estimated loss to the Deposit Insurance Fund (DIF) of \$72.5 million.<sup>47</sup>

### ***Fraud Risk***

Government-guaranteed loan programs have been the target of fraudulent actors seeking financial gain. According to the FDIC RMS Manual, “[c]riminal conduct and fraudulent acts undermine public confidence in the financial system and contribute to financial institution failures. Confidence is especially eroded when offenses involve bank insiders. When failures occur, the FDIC Deposit Insurance Fund can suffer significant losses.”<sup>48</sup>

The OCC issued a bulletin on Operational Risk, which highlights fraud risk:<sup>49</sup>

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<sup>46</sup> OIG Report, [Failed Bank Review, Almena State Bank, Almena, Kansas](#) (FDIC OIG FBR-21-003) (March 2021).

<sup>47</sup> A material loss to the deposit insurance fund has been defined as any estimated loss in excess of \$150,000,000, if the loss occurred during the period beginning on January 1, 2012, and ending on December 31, 2013. FDI Act §38(k)(2). Since the estimated loss associated with Community South Bank's failure was below the material loss threshold, the FDIC OIG completed a failed bank review to meet requirements associated with losses that are not material and summarized the results of the review in the October 2014 [Semiannual Report to the Congress](#), FDI Act § 38(k)(5). Since February 2018, in addition to summarizing the results of any such reviews in the Semiannual Reports to the Congress, the FDIC OIG has issued separate failed bank review reports.

<sup>48</sup> *FDIC RMS Manual*, Section 10.1, Suspicious Activity and Criminal Violations (November 2017).

<sup>49</sup> OCC Bulletin 2019-37, *Operational Risk: Fraud Risk Management Principles* (July 2019).

Fraud risk is a form of operational risk, which is the risk to current or projected financial condition and resilience arising from inadequate or failed internal processes or systems, human errors or misconduct, or adverse external events. Operational risk management weaknesses can result in heightened exposure to fraudulent activities, which can increase a bank's exposure to reputation and strategic risks. Failure to maintain an appropriate risk management system could expose the bank to the risk of significant fraud, defalcation (e.g., misappropriation of funds by an employee), and other operational losses.

### **Fraud in Government-Guaranteed Loans and in the Paycheck Protection Program:**

The FDIC OIG in coordination with the U.S. Department of Justice have publicly reported on multiple significant investigations of alleged fraudulent activities associated with Government-guaranteed loan programs<sup>50</sup> since 2016 (see Appendix 4, summarizing these fraud investigations). Most of these investigations involved bank insiders and bank-associated third parties colluding over multiple years to abuse Government-guaranteed loan programs for personal profit or to transfer the risk of failing assets to the Government. In September 2022 a regional bank in Texas settled an allegation of PPP loan fraud.<sup>51</sup> The bank processed a loan in violation of PPP loan requirements to an individual who was known to the bank to be under criminal charges. As a result, the bank was required to pay back its loan processing and other fees totaling over \$18,600. In another case, the Board of Governors of the Federal Reserve System (FRB) imposed a \$2.3 million civil money penalty on a bank for processing PPP loans that had known indications of fraud and for not reporting the fraud timely.<sup>52</sup>

According to the OCC Semiannual Risk Perspective<sup>53</sup> (Spring 2021), programs such as the PPP “featured increased compliance responsibilities, high transaction volumes, and new fraud typologies, at a time when banks continue to respond to a changing operating environment.”<sup>54</sup> The report presented that “it is essential for [banks] to conduct appropriate due diligence commensurate with the risks that the new services and providers pose to the bank, and to monitor third-party activities to ensure compliance with applicable laws and regulations.”

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<sup>50</sup> This does not include fraud related to PPP loans, which is presented separately below.

<sup>51</sup> Department of Justice, United States Attorney's Office, Southern District of Texas, *First-ever False Claims Act settlement received from Paycheck Protection Program lender* (September 2022).

<sup>52</sup> FRB, *Federal Reserve Board announces it has fined Popular Bank \$2.3 million for processing six Paycheck Protection Program (PPP) loans despite having detected that the loan applications contained significant indications of potential fraud* (January 2023).

<sup>53</sup> The OCC issues Semiannual Risk Perspective reports that address key issues facing banks, focusing on those that pose threats to the safety and soundness of banks and their compliance with applicable laws and regulations.

<sup>54</sup> OCC, *Semiannual Risk Perspective* (Spring 2021).

Other Federal agencies, academic researchers, and advocacy groups have reported on the fraud and accompanying financial institution reputational risks and legal risks associated with the SBA PPP. For example, a study by the McCombs School of Business, University of Texas, Austin (August 2022) determined that around 1.4 million of the 11.5 million PPP loans — more than 12 percent — and representing \$64.2 billion — had at least one indication of potential fraud.<sup>55</sup> This study stated that this figure is likely substantially understated, and total suspicious lending may be as high as \$117.3 billion.

Further, the SBA OIG reported in January 2021 that nearly 55,000 PPP loans worth \$7 billion went to potentially ineligible businesses or fraudulent recipients.<sup>56</sup> According to a report by the Pandemic Response Accountability Committee (PRAC)<sup>57</sup> (January 2022), the SBA stated that the more rigorously that PPP lenders applied “Know Your Customer”<sup>58</sup> requirements, the more likely that individual loan fraud issues, like identity theft, would be identified.<sup>59</sup>

The Congressional Select Subcommittee on the Coronavirus Crisis requested that two banks, (b) (8) both FDIC-supervised institutions, provide documents and information related to their origination of PPP loans to understand the PPP fraud detection processes applied by FinTech<sup>60</sup> lenders and their bank and non-bank partners.<sup>61</sup> The Select Subcommittee referenced materials and information describing fraud associated with PPP loans approved by (b) (8). The Select Subcommittee’s investigation found that FinTechs failed to stop obvious and preventable fraud.<sup>62</sup> It also found that the lending partners of the FinTechs often did little to oversee the activities of the companies to which they delegated their responsibilities.

According to a Memorandum issued on June 13, 2022 by the U.S. House of Representatives, Select Subcommittee on the Coronavirus Crisis, the Government has criminally charged 1,481 defendants related to 1,003 pandemic relief fraud investigations involving more than \$1 billion in losses.<sup>63</sup> The FDIC OIG alone has

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<sup>55</sup> McCombs School of Business, University of Texas at Austin, *Did FinTech Lenders Facilitate PPP Fraud?* (Updated August 2022).

<sup>56</sup> SBA OIG Report, *Inspection of SBA’s Implementation of the Paycheck Protection Program (21-07)* (January 2021).

<sup>57</sup> The CARES Act created the PRAC to support and coordinate independent oversight of pandemic relief spending.

<sup>58</sup> In an effort to mitigate the risk of fraud and money laundering activities in the banking sector, the BSA requires, among other things, that federally regulated financial institutions establish a customer identification program and conduct ongoing customer due diligence to verify the identity of and monitor customers. These requirements are generally referred to as “Know Your Customer.”

<sup>59</sup> PRAC, *Small Business Administration Paycheck Protection Program Phase III Fraud Controls* (January 2022).

<sup>60</sup> FinTechs are companies that use technology to support banking and financial services.

<sup>61</sup> Congress of the United States, House of Representatives Select Subcommittee on the Coronavirus Crisis, (b) (8)

<sup>62</sup> Congress of the United States, House of Representatives Select Subcommittee on the Coronavirus Crisis, *“We Are Not The Fraud Police”: How Fintechs Facilitated Fraud In The Paycheck Protection Program* (December 2022).

<sup>63</sup> Congress of the United States, House of Representatives Select Subcommittee on the Coronavirus Crisis, *The Biden Administration’s Efforts to Root Out Fraud in Pandemic Relief Programs and Bring Wrongdoers to Justice* (June 2022). These numbers reflect fraud within other pandemic relief programs beyond the PPP.

initiated 154 investigations related to PPP, as of March 31, 2022 (see Appendix 5 for examples of PPP fraud investigations). FDIC OIG investigations of PPP fraud have resulted in 180 criminal charging actions, 117 arrests, 68 convictions, and recoveries of approximately \$100 million.<sup>64</sup> Insiders at FDIC-supervised or insured banks were involved in 14 percent of these investigations (22 cases).<sup>65</sup> Recognizing the significant fraud in the PPP, the President extended the statute of limitations to prosecute fraud in the PPP.<sup>66</sup>

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## EVALUATION RESULTS

FDIC examinations were not always effective in identifying and addressing risks related to Government-guaranteed loans for financial institutions that participate in Government-guaranteed loan programs. We determined that the:

- FDIC's guidance did not adequately address the risks present in Government-guaranteed loan programs;
- FDIC could improve its supervision of bank activities in Government-guaranteed loan programs, including the Paycheck Protection Program;
- FDIC's guidance differed from that of other Federal bank regulators;
- FDIC did not provide adequate training to examination personnel on Government-guaranteed lending programs;
- FDIC did not maintain adequate data to identify, monitor, and research bank participation in Government-guaranteed loan programs; and
- FDIC did not effectively share information externally and internally to enhance risk oversight of banks that participated in Government-guaranteed loan programs.

Moreover, the FDIC examination guidance did not provide clear instructions on the retention of examination workpapers.

During this evaluation, FDIC officials stated that Government-guaranteed loans have historically not caused a financial burden to the FDIC. The FDIC views these programs primarily as credit risk mitigants, and FDIC officials stated that FDIC examiners emphasize credit risk above other risk factors, as it is historically the most direct cause of bank failures. We found instances in which FDIC examiners – when observing clear violations of program requirements, or unsafe and unsound banking practices – did not question the financial institution's ability to collect on the

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<sup>64</sup> This information is as of March 31, 2022. Criminal charging actions include complaints, informations, indictments, superseding indictments, and superseding informations. The recoveries includes fines, restitution ordered, and asset forfeiture. It does not include seizures and cost avoidance monies.

<sup>65</sup> Insiders include financial institution executive managers, employees, and the financial institution.

<sup>66</sup> Public Law No. 117-166, 136 Stat. 1365 (August 5, 2022).

Government-guaranty. FDIC officials and examination staff asserted that the Federal agencies administering the Government-guaranteed loan programs are responsible for determining the validity of the guaranty.

However, the FDIC is responsible for examining the safety and soundness practices and compliance with consumer protection laws for supervised financial institutions. In addition, the statements of FDIC's officials were not consistent with its guidance for examiners. Specifically, the FDIC RMS Manual established the responsibility for examiners to determine whether Government-guaranteed loans issued by a bank are compliant with the underlying guaranty issued by another agency. Further, consistent with statutory authorities, the FDIC RMS Manual and examination guidance from other Federal financial regulators established the authority for examiners to criticize or classify these assets in the event that noncompliance with Government-guaranteed loan program requirements is determined or inadequate risk management by the bank is observed.

Until the FDIC addresses the recommendations in this report, there is risk that the safety and soundness of certain financial institutions participating in Government-guaranteed loan programs may deteriorate, leading to failure or consumer harm and ultimately increased risk or loss to the DIF. As detailed in this report, multiple FDIC-supervised financial institutions have realized risk from applying imprudent banking practices or perpetrating fraud in Government-guaranteed loan programs. Such activities contributed to the failure of multiple FDIC-supervised financial institutions including Almena State Bank, Valley Bank, and Community South Bank. These failures resulted in estimated losses to the FDIC's DIF of over \$140 million.

### **FDIC Guidance Did Not Adequately Address Risks in Government-Guaranteed Loan Programs**

The FDIC provided limited guidance<sup>67</sup> for examiners and Case Managers to understand the risks related to Government-guaranteed loan programs. The FDIC guidance did not address or provide sufficient detail on the unique operational risk, credit risk, compliance risk, servicing risk, liquidity risk, and strategic risk arising from bank activities in these programs. In addition, FDIC guidance did not provide detailed information to allow examiners and Case Managers to consistently assess bank activities in Government-guaranteed loans for loan classification, off-balance sheet risk, concentration risk, and ongoing monitoring.

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<sup>67</sup> For the purposes of this report, guidance includes policies, procedures, manuals, memorandums, handbooks and bulletins.

According to the U.S. Government Accountability Office (GAO) Standards for Internal Control in the Federal Government, “[i]nternal control comprises the plans, methods, policies, and procedures used to fulfill the mission, strategic plan, goals, and objectives of the entity.”<sup>68</sup> In addition, GAO’s A Framework for Managing Fraud Risks in Federal Programs (Fraud Risk Management Framework) notes that managers who effectively manage fraud risks design and implement specific control activities—including policies, procedures, techniques, and mechanisms—to prevent and detect potential fraud.<sup>69</sup>

However, the FDIC did not maintain separate internal policies, procedures, and guidance for Government-guaranteed loan programs, other than a memorandum specific to the SBA Paycheck Protection Program (RMS Regional Directors Memorandum (RD Memo) 2020-022-RMS (June 2020)). FDIC officials stated that the FDIC RMS Manual applied both to guaranteed loans and non-guaranteed loans. However, the FDIC RMS Manual does not distinguish between the different loan structures, requirements, and associated risks for Government-guaranteed loans. We found that the FDIC guidance could be improved as it (1) lacked guidance on risks unique to Government-guaranteed loan programs that banks face, and (2) lacked guidance on loan classification, off-balance sheet risk, concentration risk, and monitoring for Government-guaranteed loans.

### ***Guidance on Risks of Government-Guaranteed Loan Programs to Banks***

**Operational and Fraud Risks:** Government-guaranteed loan programs are often complex and have unique requirements for compliance and underwriting that require specialized knowledge. In addition, Government-guaranteed loan programs have been the target of fraudulent actors seeking financial gain. The FDIC RMS Manual does not discuss the operational risks, including fraud risk, associated with Government-guaranteed loan programs for consideration by supervision staff during monitoring, examination planning, and examination execution. As a result, FDIC examination staff are not provided guidance regarding these risks for bank participation in Government-guaranteed loan programs. Such guidance could assist FDIC examiners in fraud detection techniques, in applying sound judgment, and in the appropriate identification and response to indications of fraudulent acts.

According to the GAO’s Fraud Risk Management Framework, “[t]he expectation that government will detect and punish fraud helps deter would-be fraudsters.” It also states that, “the likelihood that individuals who engage in fraud will be identified and punished serves to deter others from engaging in fraudulent behavior.” Individuals aware of the limited guidance on FDIC examinations over a financial institution’s

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<sup>68</sup> GAO-14-704G, *Standards for Internal Control in the Federal Government* (September 2014).

<sup>69</sup> GAO-15-593SP, *A Framework for Managing Fraud Risks in Federal Programs* (July 2015).

participation in Government-guaranteed loans may be more likely to commit fraud in these programs.

According to the FDIC RMS Manual, “[the] early detection of apparent fraud and insider abuse is an essential element in limiting the risk to the FDIC’s deposit insurance funds and uninsured depositors.” If FDIC examiners are not aware of the fraud trends or past fraud schemes related to Government-guaranteed loans, they may not identify future occurrences and report them to the appropriate authorities. Themes in Government-guaranteed fraud investigations involved:

- **Disguising impermissible use of proceeds as working capital:** Ineligible use of proceeds such as past-due payroll taxes and personal debt were falsely presented on loan applications as working capital to cover business operating expenses;
- **Using working capital loan proceeds to fund the borrower’s equity injection:** In certain circumstances, as part of a loan transaction, owners of a borrower (small business) are required to inject cash into the business as equity capital. Loan proceeds were falsely designated on the loan settlement statement as working capital and instead used to fund the borrower’s required equity injection;
- **Masking bank insider ownership interests:** The Chief Executive Officer (CEO) of a bank secretly solicited and received bribed payments on Government-guaranteed loans issued by the bank in which the CEO had secret ownership interests; and

Since 2016, there are several examples where bank insiders and third parties colluded to abuse Government-guaranteed loan programs for personal profit or to pass the bank’s risk for failing assets on to the Government.

In one investigation involving Banc-Serv Partners, LLP, a lending service provider, the defendants and co-conspirators originated dozens of loans, totaling over \$10 million in disbursements, which were not eligible for the Government-guaranties. The defendants and co-conspirators, including bank and third party employees, made false statements on loan-guaranty applications and purchase requests, such as misrepresenting the use of loan proceeds.

In another investigation, the owner of a Louisiana company was indicted for lying on applications for Government-guaranteed loans. The defendant provided inflated estimates of his inventory to an appraiser he hired and presented inflated and fraudulent appraisals in loan guaranty applications with the Department of Agriculture and SBA for two loans totaling \$4 million at banks in Texas and Louisiana. Both loans went into default, causing a total loss of approximately \$1.1 million to the banks.

- **Falsifying documents and masking fees:** Loan brokers were charged with allegedly fabricated federal tax forms submitted in support of fraudulent loan applications, falsified applicant signatures, and falsely indicated that no broker had assisted in preparing or referring the loan applications. The loan brokers allegedly charged borrowers fees for obtaining the fraudulent loans.

**Credit and Compliance Risks:** The FDIC RMS Manual did not provide adequate guidance on the unique credit and compliance risks associated with Government-guaranteed loans.

While the International Banking section<sup>70</sup> within the FDIC RMS Manual provides that examiners should review documents to determine whether Government-guaranteed loans comply with program conditions, it does not describe the program requirements and conditions that may render a guarantee invalid, such as:

- Borrower eligibility,
- Creditworthiness,
- Repayment ability,
- Use of proceed restrictions, and
- Citizenship requirements.

It also does not refer examination staff to any additional resources, such as FDIC reference materials or training guides, from which examiners can obtain the specific conditions and requirements of agency Government-guaranteed loan programs.<sup>71</sup> In addition, the International Banking section in the FDIC RMS Manual may not be routinely referenced by examination staff evaluating the domestic activities of financial institutions.<sup>72</sup>

Bank negligence or material noncompliance with these requirements can impact the performance of the loan and ultimately result in the Federal agency administering the Government-guaranteed loan program to reduce or cancel the guaranty. For example, a Federal agency may rescind its guaranty if a bank makes a loan to an ineligible borrower or to a borrower that lacks creditworthiness or repayment ability.

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<sup>70</sup> According to the *FDIC RMS Manual*, the International Banking section "provides a broad perspective of international banking. It begins by addressing the concept of country risk, which is the primary risk associated with international banking activities. The section then discusses common international banking products and services such as foreign loans, investments, placements, currency exchange, and funds management."

<sup>71</sup> Additional resources also include the standard operating procedures and regulations of the Federal agencies that administer the programs.

<sup>72</sup> The Government-guaranteed loan programs focus on assistance to domestic businesses and individuals.

**Servicing Risk:** Servicing activities within Government-guaranteed loan programs include, among other things, loan monitoring, perfecting liens on collateral, and processing loan payments. For servicing risk, the FDIC RMS Manual states that “[e]xaminers should be aware of the risks that can affect an institution from the failure to follow the servicing rules related to securitized assets.”<sup>73</sup> The FDIC RMS Manual states that “[i]n most cases, the government agency that provided the guarantee or insurance against ultimate default will also impose guidelines and regulations for the servicer to follow. If the servicer or others involved in the servicing function fail to follow the rules and guidelines, then the government agency that is providing the guarantee or insurance may refuse to honor its commitment to insure all parties against loss due to default.”

The FDIC guidance, however, does not describe how examiners should treat the Government-guaranteed loans when these risks occur. For example, the FDIC RMS Manual does not articulate how examiners should consider or evaluate the off-balance sheet risk<sup>74</sup> for financial institutions that sell Government-guaranteed loans to third-party investors and are non-compliant with program servicing requirements. Without proper guidance, examiners may not ensure banks have established adequate liability accounts for off-balance sheet risk.

**Liquidity and Strategic Risks:** The FDIC RMS Manual did not address the unique liquidity and strategic risks arising from bank activities in Government-guaranteed loan programs. As described above, a bank may rely on selling Government-guaranteed loans to meet its liquidity needs. However, if the bank gets suspended or is prohibited from selling loans in the secondary market due to material noncompliance with program requirements, it can significantly affect its business model and liquidity. As a result, a bank may be unable to meet its contractual or financial obligations in a timely manner. Further, banks that engage in new, expanded, or modified Government-guaranteed lending activities are exposed to strategic risk as market demand changes could make the activity no longer economical.<sup>75</sup>

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<sup>73</sup> *FDIC RMS Manual*, Section 3.7, Other Assets and Liabilities (March 2012).

<sup>74</sup> Off-balance sheet risk is associated with the potential losses on Government-guaranteed loans sold on the secondary market. The *FDIC RMS Manual* states that contingent liabilities reflect potential claims on bank assets. Any actual or direct liability that is contingent upon a future event or circumstance may be considered a contingent liability. It further states that a loss contingency is an existing condition, situation, or set of circumstances that involves uncertainty as to possible loss that will be resolved when one or more future events occur or fail to occur.

<sup>75</sup> OCC Bulletin 2021-34, *Small Business Administration Lending: Risk Management Principles* (August 2021).

### ***Guidance on Loan Classification, Assessment of Off-Balance Sheet Risk, Concentration Risk, and Monitoring Specific to Government-Guaranteed Loans***

**Loan Classification:** The FDIC RMS Manual does not include guidance for examiners to consider when classifying loans that have a Government-guaranty. The FDIC RMS Manual states that a financial institution must maintain an Allowance for Loan and Lease Losses (ALLL) to absorb estimated credit losses.<sup>76</sup> In assessing the appropriateness of the ALLL, examiners may review loans for credit quality and classify loans based on the degree of non-payment.<sup>77</sup> However, the FDIC RMS Manual does not describe how examiners should classify Government-guaranteed loans and assess the appropriateness of the ALLL related to Government-guaranteed loans. In addition, the FDIC RMS Manual does not detail the various situations where adverse classification of the guaranteed portion of a loan may be warranted.

**Assessment of Off-Balance Sheet Risk:** The FDIC RMS Manual instructs examiners to consider the risks associated with off-balance sheet activities when evaluating capital. The guidance explains that the impact contingent liabilities may have on capital accounts is an important consideration in rating capital. The FDIC RMS Manual states that, “[a]n estimated loss from a loss contingency...should be recognized if it is probable that an asset has been impaired or a liability incurred as of the examination date and the amount of loss can be reasonably estimated.” This requires judgment and an interpretation of accounting standards. As described above, servicing risks for financial institutions may be realized when selling loans to investors. Specifically, if the financial institution does not comply with program requirements for loan servicing, the government agency may refuse to honor the guaranty or seek recovery from the bank.

However, the FDIC RMS Manual does not describe how examiners should consider and assess the off-balance sheet risks associated with portions of Government-guaranteed loans sold to investors when they observe financial institution noncompliance with Government-guaranteed loan program requirements, including servicing requirements. The FDIC RMS Manual also does not articulate how examiners should coordinate with internal experts or other Federal agencies that administer Government-guaranteed loan programs to determine whether contingent

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<sup>76</sup> According to the *FDIC RMS Manual*, estimated credit losses is an estimate of the current amount of the loan and lease portfolio (net of unearned income) that is not likely to be collected; that is, net charge-offs that are likely to be realized for a loan, or pool of loans.

<sup>77</sup> According to the *FDIC RMS Manual*, examiners categorize adversely classified loans as Substandard, Doubtful, or Loss, based on the risk of nonpayment. Substandard loans have a weakness that jeopardizes the liquidation of debt, and pose loss to the financial institutions if deficiencies are not corrected. Loans are classified Doubtful when the collection or liquidation are highly questionable and improbable. Loans classified as Loss are regarded as uncollectible and of little value, but partial recovery may occur in the future. Loan amounts classified as Loss should be eliminated from the financial institution's books.

liabilities for Government-guaranteed loans sold on the secondary market should be established.

**Concentration Risk:** The FDIC RMS Manual does not address the treatment of Government-guaranteed loans for concentration risk. According to the FDIC RMS Manual:

Asset concentrations are pools of assets that share common risk characteristics or have heightened sensitivity to similar economic, financial, or other risk factors. An institution's asset quality, earnings, or capital can be disproportionately affected by a single or localized economic event or market conditions if the institution holds significant asset concentrations.

An FDIC-supervised bank with a large percentage of Government-guaranteed loans may be subject to concentration risk, as Government-guaranteed loans share common risk characteristics and have heightened sensitivity to similar economic, financial, or other risk factors. For example, SBA loans provide financial help for small businesses with special requirements and financial institutions sell SBA loans on the secondary market. In addition, the U.S. Department of Agriculture loans provide financial assistance to agricultural and rural businesses. An economic event, such as the recent COVID-19 pandemic, or significant climate-related event could impact the viability of these businesses.

Further, market conditions could impact the financial condition of FDIC-supervised banks that depend on selling Government-guaranteed loans to secondary market investors for earnings and liquidity. If a bank does not comply with the Government-guaranteed loan program requirements, there is a risk that the Federal agency will prohibit the bank from participating in the program, which could impact the bank's business model, earnings, and liquidity. Nevertheless, the FDIC does not provide sufficient guidance to examiners on determining concentrations in Government-guaranteed loan portfolios, including treatment of Government-guaranteed loans sold on the secondary market.

**Monitoring:** The Case Manager Procedures do not include guidance for Case Managers for monitoring FDIC-supervised institutions' activities in Government-guaranteed lending. The purpose of monitoring by Case Managers is to identify and mitigate emerging risks and to encourage a more proactive supervisory approach. Case Managers, in coordination with senior management, direct the supervisory approach for the financial institution. Without guidance on the risks of Government-guaranteed loan programs, Case Managers may not be able to properly assess the

risk and develop an informed and adequate supervisory approach for financial institutions that participate in Government-guaranteed loan programs.

### ***FDIC Perspectives on Government-Guaranteed Lending***

The FDIC does not view bank participation in Government-guaranteed loan programs as a significant risk to the FDIC. According to FDIC officials, RMS looks at banks' practices with the most risk, and government guaranteed loans typically do not fall into that category. FDIC officials stated that these Government-guaranteed loan programs are primarily credit risk mitigants and have not been the proximate cause of bank failures.<sup>78</sup>

In addition, we found the FDIC is reluctant to question the bank's ability to collect on the Government-guaranty during its examinations. As described below, we observed this reluctance in our interviews with examiners and in FDIC examinations when the FDIC concluded that the bank engaged in unsafe and unsound practices with its Government-guaranteed loan portfolio and examiners observed material non-compliance with program requirements.

This practice is inconsistent with the FDIC RMS Manual.<sup>79</sup> The FDIC guidance in its Manual requires examiners to scrutinize documents when reviewing Government-guaranteed loans to determine whether the loans are compliant with the guaranty. Further, consistent with statutory authorities, the FDIC RMS Manual and examination guidance from other Federal financial regulators establish the authority for examiners to criticize or classify Government-guaranteed loan assets in the event a bank does not comply with program requirements or has inadequate risk management practices.

In addition, the FDIC is responsible for examining the bank's safety and soundness practices and compliance with consumer protection laws and regulations for supervised financial institutions.

Absent adequate guidance, examiners may not be able to proactively and consistently identify emerging Government-guaranteed loan risks or material noncompliance that could render conditional loan guarantees at risk and negatively

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<sup>78</sup> Borrowers that receive Government-guaranteed loans are generally not able to receive conventional bank loans due to their credit, cashflow, or collateral weaknesses. The guaranty issued by the Federal agency serves as means for banks to mitigate the inherent credit risk in these loans and reduce losses.

<sup>79</sup> *FDIC RMS Manual*, Section 11.1, *International Banking* (January 2018). The *FDIC RMS Manual* states that "[a]s with any government-guaranteed financing, familiarity with the specific conditions and requirements of each agency and program is paramount. Like domestic transactions, failure by the lender to comply with the program's conditions may allow the agency to rescind the guaranty. Documentation should be maintained for each participating transaction to show compliance with the outstanding guaranty. These documents should be scrutinized by the examiner when reviewing these credits to determine that the loan is compliant with the guaranty. Failure to comply with the terms of the guaranty may warrant adverse classification or criticism by the examiner."

impact the safety and soundness of the institution. As described below, in some cases, examiners did not adequately and consistently identify and address risks related to Government-guaranteed loans for banks that participated in Government-guaranteed loan programs.

### **Recommendations:**

We recommend that the FDIC Director of RMS:

1. Develop and implement guidance to examination staff on the credit, operational (including fraud), liquidity, and compliance risks related to Government-guaranteed loans to ensure staff adequately plans and conducts examinations to identify and address emerging risks.
2. Develop and implement guidance to examination staff to ensure the staff consistently evaluate Government-guaranteed loans in their review of loan classification, assessment of off-balance sheet risk, concentration risk, and ongoing monitoring.

### **The FDIC Could Improve Its Supervision of Bank Activities in Government-Guaranteed Loan Programs**

We determined that FDIC examiners did not regularly:

- Request information related to financial institution Government-guaranteed lending activities during examination planning;
- Assess financial institution compliance with Government-guaranteed loan program requirements;
- Classify Government-guaranteed loans;
- Assess off-balance sheet risk associated with guarantees sold on the secondary market; and
- Consider guaranteed portions of loans in determining concentrations.

We analyzed FDIC examinations and visitation activities for five banks (see Table 2).<sup>80</sup>

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<sup>80</sup> As described in Appendix 1, we interviewed RMS examiners, Case Managers, and FDIC officials responsible for the examination and oversight activities of the selected banks and other FDIC-supervised financial institutions. We also interviewed additional examiners identified by RMS as having significant experience in examining the Government-guaranteed loan activities at financial institutions.

## FDIC Examinations of Government-Guaranteed Loans

**Table 2. FDIC-Supervised Financial Institutions Reviewed by the OIG**

Bank Name	Region	Total Assets <sup>a</sup>	Total (b) (8) Government-Guaranteed (b) (8) Loans Approved <sup>b</sup>
Almena State Bank <sup>81</sup>	Kansas City	\$65,733,000	\$0 <sup>c</sup>
Bank 2	(b) (8)	(b) (8)	(b) (8)
Bank 4	(b) (8)	(b) (8)	(b) (8)
Bank 5	(b) (8)	(b) (8)	(b) (8)
Bank 3	(b) (8)	(b) (8)	(b) (8)

Source: FDIC OIG Analysis of Reports of Condition and Income (Call Reports) and (b) (8).<sup>82</sup>

<sup>a</sup> These figures represent the assets reported by the banks on the December 31, 2021 Call Report. However, the assets for Almena State Bank are as of September 30, 2020. Almena State Bank failed and closed on October 23, 2020. The total (b) (8) Government-guaranteed loans approved amount should not be calculated as a percentage of total assets. The total (b) (8) Government-guaranteed loan amount is a cumulative amount of loans approved and the total assets represent the value of the assets at a point in time.

<sup>b</sup> This reflects loans approved by these banks from 2012 to 2021. The figures do not include approved loans that were cancelled. Banks may have sold (b) (8) loans on the secondary market. Accordingly, these loans may be removed from the banks' balance sheets and not reflected in the assets. Further, due to Government-guaranteed loan program data limitations in the Call Report, these data points may underreport the amount of Government-guaranteed loans approved by the financial institutions. (b) (8)

<sup>c</sup> We were unable to determine the volume of (b) (8) loans approved by Almena State Bank because it closed.

### ***Requests for Government-Guaranteed Loan Information During Examination Planning***

FDIC examiners did not consistently request financial institutions to identify Government-guaranteed loans in their loan data submissions to the FDIC during the examination planning phase. According to the FDIC RMS Manual, during the planning phase, examiners submit an Examination Profile Script (EPS) to banks to help them tailor the examination procedures to the institution's operations. The EPS includes a list of questions related to the bank's operating environment, lending areas, and deposit products. The EPS asks financial institutions whether they participate in Government-guaranteed loan programs, but it does not request any information designed to inform examiners about the size of the associated loan portfolios; the status of the individual Government-guarantees and if any are at risk for partial or full denial; or whether the loans are current, past due, or defaulted.

FDIC examiners acknowledged that additional information on banks' participation in Government-guaranteed loan activities would benefit them when planning or conducting examinations. Questions that could better inform examiners about the financial institution activities and performance in these programs include:

<sup>81</sup> Almena State Bank failed in October 2020. Because failed banks have ceased operations they are directly named in this report.

<sup>82</sup> Call Reports are consolidated reports of the bank's condition and income that must be filed by each bank on a quarterly basis. The FDIC receives loan data through the mandatory Call Reports, which provide the only bank-specific quarterly data consistently available for all banks.

- a) What is the value (in dollars) of the loan portfolio attributed to the Government-guaranteed loan programs by program type?
- b) What is the amount (in dollars) of delinquent or defaulted Government-guaranteed loans by program type?
- c) What is the amount (in dollars) of Government-guaranties that Federal agencies did not honor for each program?

FDIC examiners also submit a Safety and Soundness Request List (Request List) to financial institutions to obtain documents and portfolio information in preparation for an examination. The Request List asks financial institutions to provide a list of loans originated under a Government-guaranteed program. However, the Request List does not require the historical performance of the Government-guaranteed loan portfolio or the status of the guaranty for each loan. FDIC examiners also acknowledged that FDIC off-site tools<sup>83</sup> that indicate participation in Government-guaranteed loans are limited, and depending on the financial institution's maturity in using software, its portfolios may not identify Government-guaranteed loans.

One FDIC examiner explained that knowing the status of the guaranty for Government-guaranteed loans would be helpful during an examination due to the risk-based approach for examinations and associated time constraints. The examiner stated that one aspect of reviewing loans from an overall risk perspective is knowing whether the guaranty is valid, especially when there are identified risks to loan repayment.

According to FDIC guidance, loans typically comprise a majority of a bank's assets and ordinarily present the greatest credit risk and potential loss exposure to financial institutions. Absent sufficient information on the Government-guaranteed loan portfolio, the FDIC is limited in its ability to effectively conduct examination planning activities to identify and address emerging risks that could impact the financial institution's financial condition.

### ***Assessment of Government-Guaranteed Loans Against Program Requirements***

We determined that FDIC examiners did not consistently evaluate Government-guaranteed loans against associated program requirements. The FDIC RMS Manual states, "in all instances, examiners should sample enough credits, including new and various-sized credits, to assess the adequacy of asset quality, underwriting

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<sup>83</sup> According to the FDIC *Case Manager Procedures*, FDIC offsite rating models include the Statistical CAMELS Offsite Rating model and Growth Monitoring System. The offsite tools are used to, among other things, identify institutions with an increased likelihood of a downgrade at the next examination.

practices, and credit risk management, in order to support ROE findings and assigned ratings.”<sup>84</sup> However, only two of the nine FDIC examiners we interviewed (22 percent) stated that they would determine whether Government-guaranteed loans meet program requirements. Other FDIC examiners we interviewed stated they focused on the risk management practices over such programs or relied on other Federal agency oversight reports and other third-party audit reports<sup>85</sup> to determine whether the banks complied with program requirements.

For example, the FDIC did not consistently evaluate Bank 2’s participation in Government-guaranteed loan programs after the bank entered into a business strategy to originate

Government-guaranteed loans. Bank 2 embarked upon a business strategy to originate loans through the Government-guaranteed loan program beginning in 2013. However, there was no evidence that the FDIC reviewed Bank 2’s loans against the Federal Government Agency’s requirements during the 2015 and 2016 safety and soundness examinations.

According to an FDIC official, Bank 2’s participation in the Government-guaranteed loan program was new, and the FDIC did not consider the loan volume to be significant. During the 2017 and 2018 safety and soundness examinations, the FDIC identified issues with Bank 2’s participation in the Government-guaranteed loan program.

In (b) (8), the Federal Government Agency (b) (8) under the Government-guaranteed loan program due to Bank 2’s historically poor performance and material noncompliance with the program requirements. The Federal Government Agency, not the FDIC, identified that Bank 2 charged impermissible fees to loan applicants during a (b) (8), which was subsequent to the FDIC’s examinations of Bank 2. We conservatively estimated the impermissible fees to be \$7 million.

We also found that the FDIC did not consistently review Government-guaranteed loans to ensure banks’ compliance with program requirements for financial institutions with large Government-guaranteed loan portfolios (b) (8). For example, to highlight the inconsistency we observed, during the safety and soundness examination of Bank 3 in 2019, FDIC examiners conducted a review of the bank’s (b) (8) lending practices. The examiners

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<sup>84</sup> FDIC RMS Manual, Section 3.2, Loans (November 2020).

relied on the bank's internal auditors' review of (b) (8) loan files and (b) (8) onsite review of Bank 3 to determine whether the bank complied with (b) (8) requirements. In contrast, examiners conducted targeted reviews of Bank 4's (b) (8) program in 2018 and 2022, which included evaluating bank-originated loans against (b) (8) program requirements.<sup>87</sup> Bank 3's (b) (8) Government-guaranteed loan portfolio represented approximately 38 percent of its assets at the time of the examination. Bank 4's (b) (8) loan portfolio represented approximately 3 percent of its assets in 2018. As a result, examiners evaluated the Government-guaranteed loans against program requirements for Bank 4 while they did not do so for Bank 3 where (b) (8) exposure was more significant.

Consistent examination approaches for banks with large Government-guaranteed loan portfolios would promote the early identification of undue risks and weak risk management practices. Inconsistent examination approaches and assessments of Government-guaranteed loans for asset quality may allow significant noncompliance with program requirements or potential consumer harm to go unnoticed.

### ***Classification of Government-Guaranteed Loans***

FDIC examiners did not classify the guaranteed portion of Government-guaranteed loans despite evidence that a bank engaged in hazardous lending practices and concluding that the bank had deficient loan administration practices. Examiners also did not classify the guaranteed portion of loans when directly observing that the financial institution did not materially comply with program requirements. For example, in the case of Bank 5, FDIC examiners did not classify the guaranteed portion<sup>88</sup> of a Government-guaranteed loan retained by the bank even though they concluded that this loan may become ineligible for the Government-guaranteed program. Specifically, FDIC examiners did not classify the guaranteed portion of the loan (\$741,564), but classified the unguaranteed portion<sup>89</sup> as substandard.

Almena State Bank failed in 2020, causing an estimated loss to the DIF of approximately \$18 million.<sup>90</sup> Our previous review of the failure found that the bank had an aggressive growth strategy that focused on originating large Government-guaranteed loans, and the bank board and management did not ensure appropriate loan underwriting and credit administration. We found that the FDIC examiners

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<sup>87</sup> Bank 4 is considered a large bank and under the continuous examination process. Due to the size and complexity of large financial institutions, the FDIC generally assigns dedicated staff and employs a continuous examination process. This examination process includes regularly scheduled onsite targeted reviews.

<sup>88</sup> (b) (8)

<sup>89</sup> Examiners classified \$136,406 of the loan (outstanding balance was \$988,752). Examiners reduced the unguaranteed amount of \$247,188 by a fair value adjustment of \$110,782 to arrive at the substandard classification amount. The substandard amount of \$136,406 represents the bank's net exposure after considering the unguaranteed portion of the expected value of collateral at liquidation.

<sup>90</sup> OIG Report, [Failed Bank Review, Almena State Bank, Almena, Kansas](#) (FDIC OIG FBR-21-003) (March 2021).

alerted bank management to the increased risk associated with originating Government-guaranteed loans and the need to meet all requirements to ensure the Government guaranty. We also reported that the FDIC's supervision identified and effectively addressed the issues that led to the bank's failure. In conducting a more in-depth review of Almena's Government-guaranteed loan portfolio during this evaluation, we found that the FDIC examiners did not classify guaranteed portions of certain loans retained by the bank, even when concluding that the bank had hazardous loan administration practices for both its commercial and guaranteed loan program business lines. Classifying the guaranteed portions of these loans as Substandard or lower may have resulted in the bank setting aside additional reserves, which could have mitigated losses to the DIF.

Despite FDIC guidance providing the authority for examiners to adversely classify the guaranteed portion of loans, FDIC examiners stated that they would "never" classify the guaranteed portion of a Government-guaranteed loan, absent direct evidence that the guaranty was in jeopardy from the administering Federal agency. Classifying loans adversely results in an increase in bank reserves to offset the risk of loss.<sup>91</sup> Specifically, banks are required to maintain an ALLL that is appropriate to absorb estimated credit losses associated with the loan and lease portfolio.

### ***Assessment of Off-Balance Sheet Risk for Government-Guaranteed Loans***

FDIC examiners did not always recommend that banks appropriately disclose or recognize the off-balance sheet risk for government guaranteed loans such as establishing a contingent liability<sup>92</sup> for possible losses<sup>93</sup> to account for Government-guaranteed loans sold on the secondary market.

On loans totaling \$2.8 million originated by Almena State Bank, FDIC examiners appropriately classified the unguaranteed portion of \$972,000 as Substandard and removed the guaranteed portions of Government loans sold totaling \$1,845,000 from classification considerations.<sup>94</sup> However, the FDIC did not recommend that the bank disclose a possible loss or establish a contingent liability to address the off-balance sheet risk for the sold portion of the classified loan even though it identified

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<sup>91</sup> The ALLL must be maintained to absorb the appropriate estimated losses related to loans classified as Substandard, Doubtful, and Loss.

<sup>92</sup> According to the *FDIC RMS Manual*, contingent liabilities reflect the potential claims on bank assets. It further states that a bank's exposure to Category II contingent liabilities normally depends solely on the probability of the contingencies becoming direct liabilities. It requires examiners to deduct the contingent liability amount directly from regulatory capital. This liability account reduces regulatory capital.

<sup>93</sup> According to the *FDIC RMS Manual*, a loss contingency is an existing condition, situation, or set of circumstances that involves uncertainty as to possible loss that will be resolved when one or more future events occur or fail to occur. Potential loss refers to contingent liabilities in which there is substantial and material risk of loss to the bank. An estimated loss from a loss contingency (for example, pending or threatened litigation) should be recognized if it is probable that an asset has been impaired or a liability incurred as of the examination date and the amount of the loss can be reasonably estimated.

<sup>94</sup> The guaranteed portion of the loan was sold by Almena State Bank on the secondary market prior to the examination. The examiners observed that the bank lacked adequate collateral documentation.

deficiencies in Almena State Bank's administration of the loan, observed that the bank engaged in hazardous lending practices, and concluded that the bank had deficient loan administration practices. Approximately 6 months after the examination, the Federal Government Agency issued a letter to Almena State Bank, requesting repayment of the total amount that the Federal Government Agency had paid to the secondary market (\$1,456,187) due to the bank's failure to comply with Agency program requirements.

The FDIC, during the examination of Bank 2 in (b) (8), identified deficiencies with management's underwriting and credit administration for a Government-guaranteed loan program and in (b) (8), the Federal Government Agency that administers the program took enforcement action against Bank 2. The FDIC established an MRBA to address Bank 2's lack of appropriate risk identification and oversight of the Government-guaranteed loan program. According to the report of examination (ROE),<sup>95</sup> (b) (8),

examiners also identified that the

Federal Government Agency that administers the program denied guaranties on loans totaling (b) (8). They deducted (b) (8) from Tier 1 Capital to recognize an off-balance sheet exposure, and Bank 2 established a contingent liability to address the denial risk for these loans. However, the FDIC did not recommend that Bank 2 disclose a possible loss or establish a contingent liability to address the risk of loss related to the guaranteed portions of the other loans sold on the secondary market associated with the classified loans. The ROE acknowledged there was a high potential for off-balance sheet exposure, which represented a significant threat to the viability of Bank 2. Given the substantial risk that the Federal Government Agency that administers the program would not honor its guaranty, we believe the FDIC should have made appropriate adjustments or recommended that the Bank make disclosures to address the off-balance sheet risks for these loans. Instead, the FDIC examiners left corrective action to the discretion of the bank's Board -- which was already found by the FDIC to be unsatisfactorily managing the bank - and the FDIC recommended that the Board identify and establish reserves for any future Government-guaranteed loan denials by communicating directly with the Federal Government Agency that administers the program.

Bank 2 management established a (b) (8) reserve for off-balance sheet risk associated to potential Government-guaranteed loan denials. The FDIC examiners determined that nearly half of the "Substandard" loans and 85% of loans classified as "Loss" during the examination were Government-guaranteed loans. FDIC examiners did not recommend that Bank 2 disclose a possible loss or establish a contingent liability to address the risk of loss related to the guaranteed portions of the other sold loans.

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<sup>95</sup> RMS presents examination results in a report of examination at the conclusion of the full-scope examination.

According to the FDIC RMS Manual, examiners should review the risks and controls associated with off-balance sheet activities during examinations. FDIC examiners should assess contingent liabilities to determine the likelihood that such contingencies may result in losses to the financial institution and assess the pending impact on its financial condition. As described above, FDIC guidance states that an estimated loss from a contingent liability should be recognized if it is probable that an asset has been impaired or a liability incurred as of the examination date and the amount of loss can be reasonably estimated. FDIC officials opined that the estimated loss, in this context, would not occur until the bank receives notification that the Government will not honor the guaranty. However, we believe that waiting for a denial letter may be too late in some circumstances. These circumstances could include when the FDIC has concluded that a poorly performing bank has deficient underwriting and credit administration practices and there is clear evidence that the bank had not complied with the Government-guaranteed loan program requirements for loans that are in default.

As previously discussed, FDIC guidance does not articulate how examiners should coordinate with internal experts or other Federal agencies that administer Government-guaranteed loans to assess off-balance sheet risks and determine if the conditions meet the thresholds of being “probable” and “reasonably estimable.” Absent such guidance, we believe that the FDIC could have recommended that Almena State Bank and Bank 2 disclose the possible losses or consider the sold portions of the classified loans described above as a contingent liability and deduct any associated amounts from Tier 1 Capital. Establishing reserves to address contingent liabilities reduces the potential loss to the DIF in the event of a bank failure.

### ***Assessment of Government-Guaranteed Loans for Concentration Risk***

FDIC examiners did not consistently identify Government-guaranteed loans as concentrations for banks. For example, they did not identify Government-guaranteed loans retained on the balance sheet as a concentration for one financial institution, but did for two others.<sup>96</sup> Concentrations in a single area have the potential to harm the bank’s financial condition. Therefore, it is important to identify concentrations and assess the risk they have on a bank’s financial condition.

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<sup>96</sup> According to FDIC guidance, asset concentrations are generally (1) 25% or more of Tier 1 Capital plus the ALLL or the ACL related to loans and leases (for loans) or Tier 1 Capital (for securities and all other) by individual borrower, small interrelated group of individuals, single repayment source or individual project; or (2) 100% or more of Tier 1 Capital plus the ALLL or the ACL related to loans and leases (for loans) or Tier 1 Capital (for securities and all other) by industry, product line, type of collateral, or short term obligations of one financial institution or affiliated group. These assets may in aggregate present a substantial risk to the safety and soundness of the institution.

**Bank 2:** FDIC examiners determined that the Government-guaranteed loan program for Bank 2 was a concentration, based on the portion of the loans retained by the bank (on-balance sheet), with minor exception.<sup>97</sup> The FDIC identified that the unguaranteed portion of Bank 2's Government-guaranteed loans represented 242 percent of Total Capital and 69 percent of Total Loans. The FDIC also determined that the total exposure of on-balance sheet Government-guaranteed loans (guaranteed and unguaranteed) was 309 percent of Total Capital.

**Bank 5:** FDIC examiners determined the bank had a concentration based on its Government-guaranteed loan program. The entire Government-guaranteed loan program was a concentration based on combining the guaranteed and unguaranteed portions of loans retained by the bank. The FDIC examiners also determined the Government-guaranteed loan program was a concentration based solely on the unguaranteed portions retained by the bank. The FDIC examiners identified that (b) (6) loans (b) (8) retained by the bank represented 720 percent of Tier 1 Capital.<sup>98</sup> They noted that the exposure was reduced to 300 percent when considering only the retained unguaranteed portions.

**Bank 3:** FDIC examiners did not identify the Government-guaranteed loan program for Bank 3 as a concentration. (b) (8) portfolio retained by the bank had an estimated concentration of 100 percent of Total Capital when considering both the guaranteed and unguaranteed portions of the loans.<sup>99</sup>

In addition, although each of the above banks sold guaranteed portions of loans on the secondary market, FDIC examiners did not calculate the off-balance sheet exposures for concentration risk purposes.<sup>100</sup> For example, (b) (8)

One FDIC examiner stated that the FDIC does not consider Government-guaranteed loans a concentration area. Rather, concentration areas include commercial real estate and commercial and industrial loans, which factor in Government-guaranteed loans, according to the examiner. Another FDIC examiner stated that obligations of Government-guaranteed loans are excluded for concentration purposes because

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<sup>97</sup> The minor exception was a small volume of Government-guaranteed loans held for sale totaling \$7.4 million.

<sup>98</sup> Per the *FDIC RMS Manual*, Tier 1 Capital is the sum of Common Equity Tier 1 Capital and additional Tier 1 Capital. In the case of Bank 5, the concentration calculation was based on Tier 1 Capital due to the bank's use of the fair value accounting method for the Government-guaranteed loans.

<sup>99</sup> Based on the FDIC concentration guidance described above, Government-guaranteed loans would be considered in the product line category. Product lines are considered a concentration when they are 100% or more of Tier 1 Capital plus the ALLL or the ACL related to loans and leases (for loans) or Tier 1 Capital (for securities and all other).

<sup>100</sup> The OCC *Concentrations of Credit Handbook* explains that effectively managing concentrations, including non-credit concentrations, is important. It further states that non-credit concentrations include operational risks associated with concentrations of certain lines of business, such as mortgage servicing.

they are considered credit risk free and as a general rule they exclude these loans from concentration calculations.

According to the FDIC RMS Manual, asset concentrations are pools of assets that share common risk characteristics or have heightened sensitivity to similar economic, financial, or other risk factors. The FDIC RMS Manual states that “[a]n institution’s asset quality, earnings, or capital can be disproportionately affected by a single or localized economic event or market conditions if the institution holds significant asset concentrations.” The FDIC RMS Manual does not have specific guidance on how examiners should consider sold portions of Government-guaranteed loans (off-balance sheet exposures) for concentration purposes.

As previously noted, market conditions can impact the financial condition of FDIC-supervised financial institutions that depend on selling Government-guaranteed loans to secondary market investors for earnings and liquidity. For example, an economic downturn could affect market participation and reduce the premium banks receive on selling the assets. Further, if a bank does not comply with the Government-guaranteed loan program requirements, there is a risk that the Federal agency will remove the bank from participating in the program, potentially impacting the bank’s business model, earnings, and liquidity. FDIC examiners are expected to analyze the potential risks and risk management practices for concentrations that exceed FDIC prescribed thresholds or present elevated risk. A consistent approach for determining concentration risk for Government-guaranteed loans is important in order to effectively analyze the financial institution risk and risk management practices. This approach could include determining whether Government-guaranteed loans present an off-balance sheet exposure concentration or qualify as a concentration solely on the unguaranteed portions or when combining the retained guaranteed and unguaranteed portions of loans.

As noted above, the FDIC provided limited guidance for examiners and Case Managers to explain the risks related to Government-guaranteed loans and the FDIC supervisory expectations for Government-guaranteed loan monitoring, pre-examination, and examination activities. In addition, the FDIC guidance did not include adequate detail for examiners and Case Managers to consistently assess bank activities in Government-guaranteed loans for loan compliance, loan classification, off-balance sheet risk, concentration risk, and monitoring.

If the FDIC does not proactively identify deficiencies -- for example, weak risk management practices, hazardous lending, inadequate ALLL, and consumer harm -- it may be unable to address the deficiencies prior to their causing harm or deterioration to the bank’s financial condition and increased risk to the DIF. In turn, this inability may impact or delay the FDIC’s capacity to issue supervisory

recommendations and enforcement actions to financial institutions to, among other things, address identified concerns, material issues, weak operations, and deteriorating financial conditions.

Further, the FDIC uses CAMELS ratings, in part, to calculate a financial institution's quarterly deposit insurance assessment.<sup>101</sup> If the FDIC does not adequately evaluate a financial institution's Government-guaranteed loan activities and correctly rate the financial institution, it will be unable to calculate the appropriate insurance assessment, commensurate with the level of risk.

The first finding in this report recommends developing and implementing guidance to ensure examination staff consistently evaluates Government-guaranteed loans in their review of loan classification, assessment of off-balance sheet risk, concentration risk, and ongoing monitoring. Therefore, we are not making a similar recommendation below.

### **Recommendations:**

We recommend that the FDIC Director of RMS:

3. Update and implement the Examination Profile Script to include additional questions on financial institution participation in Government-guaranteed loan programs in order to identify and address emerging risk.
4. Develop and implement additional items to the Safety and Soundness Request List to identify Government-guaranteed loans, the performance of those loans, and status of the guaranty.

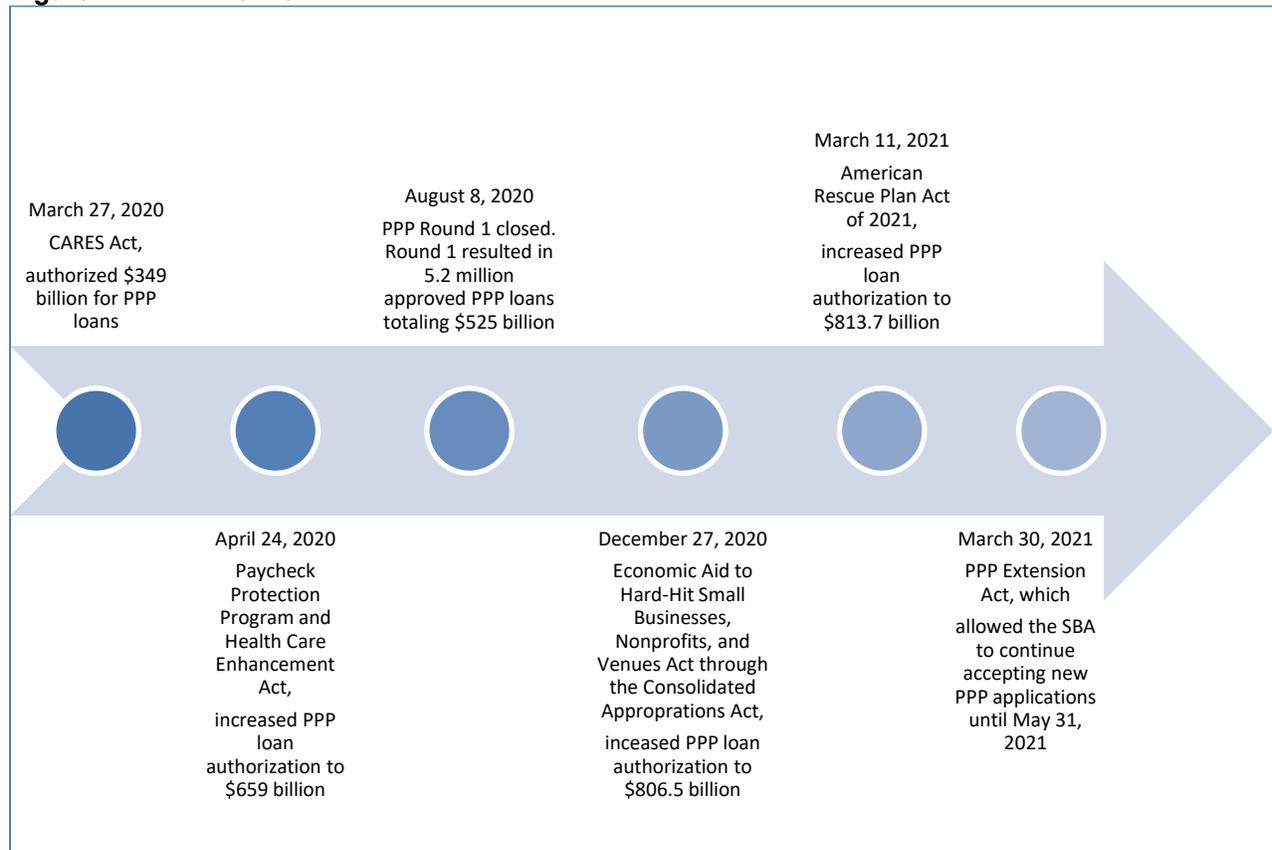
### **The FDIC Did Not Adequately Supervise Risks of the Paycheck Protection Program for Certain Banks**

The PPP presented unique challenges and risks to financial institutions due to its expedited implementation, multiple changes in guidance, and minimal underwriting requirements. On March 27, 2020, Congress enacted the CARES Act, which established the PPP, and the SBA launched the PPP on April 3, 2020. As illustrated in Figure 1, the PPP was reauthorized several times through March 2021 to continue the assistance to small businesses impacted by the pandemic. Each successive reauthorization provided for a new round of funding for the PPP.

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<sup>101</sup> The FDIC calculates the deposit insurance assessment for an individual institution using formulas that, in general, assign values to each CAMELS component and composite rating. The rate calculators are available on the FDIC website <https://www.fdic.gov/resources/deposit-insurance/deposit-insurance-fund/dif-calculator.html>. For small institutions in existence less than 5 years, the CAMELS rating may not factor into the calculation of the deposit insurance assessment rate.

Figure 1. PPP Timeline



Source: OIG analysis of the various laws that authorized the PPP and information available on SBA's website.

As previously noted, more than 11 million PPP loans totaling nearly \$800 billion were approved by more than 5,400 lenders. More than 2,600 FDIC-supervised financial institutions originated over 3 million PPP loans totaling approximately \$270 billion.<sup>102</sup> Table 3 presents the PPP volume and other information for eight financial institutions we evaluated.

<sup>102</sup> This amount excludes PPP loans that were cancelled or voluntary terminated subsequent to original approval. We were unable to determine the full amount of PPP loans associated with FDIC-supervised institutions due to a lack of unique identifiers in the PPP loan data. Further, this amount reflects any changes made after origination.

(b) (8)

[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
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[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

[REDACTED]

[REDACTED]

We found that, in some instances, FDIC examiners did not adequately (1) review PPP loan portfolios commensurate with the degree of an institution’s participation in the program and identified concerns;<sup>104</sup> (2) assess bank processes to confirm that PPP lending decisions were made in accordance with SBA guidelines and BSA requirements; and (3) determine whether an institution had an adequate risk management framework sufficient to confirm third-party compliance with SBA requirements for PPP, BSA requirements, and other applicable laws and regulations.

Such practices were not consistent with the FDIC’s requirements. FDIC RD Memo 2020-022-RMS, Examination Considerations Related to the Paycheck Protection Program, states that:

The scope of review of the PPP loan portfolio should be commensurate with the degree of an institution’s participation in the program and with any concerns identified, such as concerns with documentation standards that could adversely impact the enforceability of the SBA guarantee or suspicion of fraud.

<sup>103</sup> RADD is the official recordkeeping system for the FDIC’s supervisory business records.  
<sup>104</sup> These concerns included documentation weaknesses, existing financial institution BSA/AML weaknesses, and indications of fraud.

Further, the BSA, as amended, requires Federally-supervised financial institutions to verify the identity of any persons seeking to open an account to the extent reasonable and practicable; maintain records of the information used to verify a person's identity, including name, address, and other identifying information; and consult lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any Government agency to determine whether a person seeking to open an account appears on any such list.<sup>105</sup>

### *FDIC Examination of Bank 1*

(b) (8)

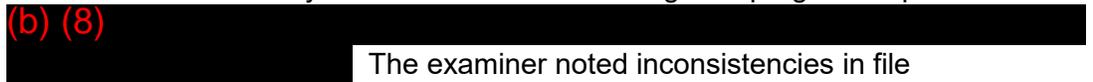


(b) (8)



During the safety and soundness examination conducted by the FDIC in 2020, the examiners selected only 12 PPP loans for review against program requirements.

(b) (8)



The examiner noted inconsistencies in file documentation and that 3 of the 12 sampled loans were missing information related to BSA compliance, such as business identification and background information. However, there was no documentation or evidence supporting that the FDIC

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<sup>105</sup> 31 U.S.C. §§ 5311-5336; 31 C.F.R. Part 1020 (2021).

<sup>106</sup> (b) (8) according to the McCombs School of Business (University of Texas at Austin), "[f]intech loans [issued through the PPP] are highly suspicious at a rate of over six times that for traditional lenders." (*Did FinTech Lenders Facilitate PPP Fraud?*, Updated August 2022).

<sup>107</sup> The FDIC communicates significant recommended improvements to financial institutions in the Report of Examination as MRBAs. When bank management promptly takes action to address concerns detailed in MRBAs, potential problems can be fixed early, before they become more difficult to address.

examiner evaluated the documentation and BSA weaknesses against the bank's (b) (8).<sup>108</sup>

Given the known weaknesses with the bank's (b) (8), the documentation weaknesses for its PPP loans, and association to fraudulent PPP loan originations, additional scrutiny and testing of Bank 1's PPP activities was warranted. (b) (8)

(b) (8) Additional scrutiny and testing of PPP activities by examiners could have identified weaknesses in Bank 1's administration of the PPP loans, resulting in recommendations to address the weaknesses during the (b) (8) examination and accounting for the bank's future PPP activities. We note that the FDIC increased its supervision of Bank 1 in 2021. The FDIC assigned a designated examiner-in-charge to Bank 1 in (b) (8), because they were moving Bank 1 to a continuous examination approach.<sup>109</sup>

### ***FDIC Examination of Bank 4***

During the FDIC's safety and soundness examination of Bank 4 in (b) (8), the FDIC examiners identified material (b) (8) that resulted in an MRBA.<sup>110</sup>

(b) (8) FDIC examiners also explained that fraud was a concern and a consideration for them because PPP loans could impact the balance sheet and earnings. Examiners selected nine PPP loans as part of their review of the bank's compliance with BSA/AML customer identification program requirements.<sup>111</sup> However, the degree of the bank's participation in the PPP, known BSA/AML weaknesses at Bank 4, and fraud concerns associated with the PPP, warranted broader transaction testing of the bank's PPP loans by examiners to determine compliance with PPP requirements.

Instead, FDIC examiners noted that they monitored Bank 4's PPP loan volumes, reviewed the bank's controls over PPP, and were in regular contact with bank management regarding PPP. The degree of the bank's participation in the PPP,

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<sup>108</sup> According to the *FDIC RD Memo 2020-022-RMS*, "[i]f the institution originated PPP loans through, or jointly with, a third-party lender, or is using platforms developed by a third party, examiners should review whether the institution has a risk management framework to confirm that third parties are complying with SBA requirements, BSA requirements, and other applicable laws and regulations."

<sup>109</sup> According to the *FDIC RMS Manual*, "[a] dedicated or designated [examiner-in-charge] oversees the continuous examination process and may be supported by additional dedicated examination staff and other staff depending on the size, complexity, and risk profile of the institution being examined."

<sup>110</sup> (b) (8)

<sup>111</sup> For PPP loans to new customers, banks were expected to apply their existing risk-based approach to BSA compliance. Banks were also required to collect identifying information, such as name, title, address, and tax identification number, from all natural persons with a 20-percent or greater ownership stake in the applicant business.

known BSA/AML weaknesses, and fraud concerns with the PPP, warranted transaction testing of the bank's PPP loans by examiners.

### ***FDIC Examinations of the Other Six Banks***

For the other six financial institutions we evaluated, we found that the FDIC conducted PPP loan transaction testing during safety and soundness examinations to determine whether the financial institutions complied with PPP requirements. For example, during the 2020 commercial loan targeted review for Bank 6, the examination team identified that Bank 6 originated (b) (8). The examination team selected and reviewed 11 PPP loans with a total balance of (b) (8). This sample size was one less loan than the Bank 1 examination sample size when Bank 1 originated approximately (b) (8). In addition, during the 2020 safety and soundness examination for Bank 7, the examiners identified that Bank 7 originated about (b) (8) PPP loans totaling approximately (b) (8). The examiners still selected and reviewed six PPP loans totaling approximately (b) (8). As presented in Table 3, (b) (8)

Based on our observations, the FDIC appeared to apply inconsistent examination approaches for the PPP loan activities of financial institutions and did not give proper consideration to existing BSA/AML weaknesses and PPP portfolio size when determining the extent of transaction level testing.

### ***Consideration of Risk for the Paycheck Protection Program***

The FDIC does not view bank participation in the SBA PPP as a significant risk to the FDIC. FDIC guidance supported and FDIC officials stated, citing law and PPP interim final rules, that unless the financial institution committed fraud in implementing the PPP or did not comply with the obligations of the PPP, there is no credit risk given that the PPP loans were 100-percent guaranteed by the SBA. In addition, based on the law and several interim final rules issued for the PPP, FDIC officials stated that the established PPP requirements were relaxed and simplified to expedite the disbursement of funds, that the requirements rendering the guaranty void were minimal, and that the program had a "low bar" for participation and loan forgiveness. According to an FDIC senior official, even though there is the potential for operational risk and compliance risk in banks, the risks are low with respect to the banks' PPP portfolios.

However, PPP loans introduce credit risk to financial institutions that did not comply with PPP requirements as the SBA can review the loans to determine program compliance and may rescind all or a portion of its guaranty if it does not find

compliance. In addition, fraud risk was elevated for the program, and an FDIC-supervised bank's association to fraudulent transactions can lead to both reputational harm and legal risk for the financial institution.

### ***The FDIC's Guidance Related to the Paycheck Protection Program***

We found that the guidance contained in the FDIC's RD Memo 2020-022-RMS on the supervision of bank participation in PPP was vague:

- The FDIC RD Memo failed to specify the level of PPP loan volume that triggers a heightened review of a bank's controls over the PPP loan program and the effectiveness of such controls or how examiners should assess the PPP activities of banks that had existing BSA/AML weaknesses.
- The FDIC RD Memo guidance did not address how indicators would increase the likelihood of fraud and should be considered by examiners. Such indicators include existing BSA/AML weaknesses, deficient underwriting practices, inadequate oversight of third parties (including FinTech lenders), and any evidence of fraud associated with bank loan approvals.
- The FDIC RD Memo guidance did not establish any expectations for examination staff to communicate observed concerns with the SBA.

According to OCC guidance, operational risk management weaknesses can result in heightened exposure to fraudulent activities, which can increase a bank's exposure to reputation and strategic risks. Failure to maintain an appropriate risk management system could expose banks to the risk of significant fraud, defalcation, and other operational losses.<sup>112</sup> The guidance states that the actual cost of fraud is greater than the direct financial loss and includes the time and expense to investigate, loss of productivity, potential legal and compliance costs associated with remediation, and impact on a bank's reputation.

Fraud risk was elevated for the PPP due to its expedited delivery, minimal underwriting requirements for applicants, and evolving guidance.<sup>113</sup> Thorough and consistent assessment of bank PPP activities during certain FDIC examinations may have resulted in the timely identification of inadequate risk management practices and corrective actions by banks. (b) (8)

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<sup>112</sup> OCC Bulletin 2019-37, *Operational Risk: Fraud Risk Management Principles* (July 2019).

<sup>113</sup> The OCC issued four semi-annual risk perspective reports between June 2020 and December 2021 that highlighted the increased compliance risks, especially BSA/AML compliance, at banks associated with PPP lending and the introduction of new fraud techniques.

According to the FDIC RMS Manual, criminal conduct and fraudulent acts undermine public confidence in the financial system, as well as contribute to financial institution failures. The occurrence of fraud at both FDIC-insured and FDIC-supervised institutions also increases reputational and legal risks to the financial institutions and the FDIC. In turn, these factors ultimately increase risk to the DIF if the FDIC is required to absorb losses from a bank failure. Without adequate reviews of PPP loan portfolios across FDIC-supervised institutions, there is a risk that exposes these financial institutions to unanticipated financial, operational, and reputational costs.

### **Recommendations:**

We recommend that the Director of RMS:

5. Issue and implement guidance to require that examination staff conduct a fraud risk assessment on future Government-guaranteed loan programs involving FDIC-insured and FDIC-supervised financial institutions to inform policy decisions.
6. Ensure guidance on future Government-guaranteed loan programs includes all risks associated with such programs and has instructions to allow for consistency in supervisory activities.
7. Issue and implement guidance for examiners clarifying the FDIC supervisory expectations for reviewing bank PPP activities, including the level of PPP loan volume triggering a heightened review, how examiners should assess the PPP activities of banks that have existing BSA/AML weaknesses, and protocols for examination staff to communicate observed weaknesses.

### **The FDIC's Guidance on Examination of Financial Institutions Differed from Other Federal Bank Regulators**

The Federal Financial Institutions Examination Council (FFIEC) prescribes uniform principles, standards, and report forms for the Federal examination of financial institutions and makes recommendations to promote uniformity in the supervision of financial institutions. The FFIEC consists of the FDIC, FRB, OCC, National Credit Union Administration, and the Consumer Financial Protection Bureau.<sup>114</sup> We determined that the FDIC's guidance for the assessment of Government-guaranteed loan programs differed from that of two other Federal regulators, the FRB and the OCC.

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<sup>114</sup> Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA), 12 U.S.C. § 3303 (2010).

### *Concentrations*

The FRB and OCC consider extensions of credit in a certain product line or type of collateral (such as a Government-guaranty) to be a concentration when, in aggregate, they exceed 25 percent of the bank's capital.

- The FRB identifies a concentration of credit when an institution advances extensions of credit and contingent obligations to a person, entity, or affiliated group that, when aggregated, exceed 25 percent of the bank's capital.<sup>115</sup> FRB guidance requires examiners to include a concentrations page in the report of examination if there are materially deficient practices in managing concentrations. FRB guidance states that “[c]oncentrations by industry, transfer risk, product line, type of collateral, and other characteristics should be detailed when appropriate. The listing should include amounts due from depository institutions, federal funds sold, and other assets in which payment depends on one financial institution or affiliated group and the total represents 25 percent or more of the bank's capital structure.”<sup>116</sup> FRB guidance also acknowledges that off-balance sheet risks should be considered when calculating concentrations.
- The OCC defines a concentration “as the sum of direct, indirect, or contingent obligations exceeding 25 percent of the bank's tier 1 capital plus the allowance for loan and lease losses (ALLL) or allowance for credit losses (ACL), as applicable.”<sup>117</sup> According to the OCC, concentrations are “common pools of exposures, whose collective performance has the potential to affect a bank negatively even if each individual transaction within a pool is soundly underwritten. When exposures in a pool have a common characteristic or sensitivity to the same economic, financial, or business development, that characteristic or sensitivity, if triggered, may cause the sum of the transactions to perform or react similarly.” OCC guidance requires examiners to include a concentration section in the report of examination when concentration levels pose a challenge to management or present unusual or significant risk to the bank.

In contrast, FDIC examiners are required to list industry or product line concentrations, which could include Government-guaranteed loans, when the loans, in aggregate, equal 100 percent or more of Tier 1 Capital plus the entire ALLL, or the

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<sup>115</sup> FRB, *Commercial Bank Examination Manual*, Section 2050.1, Concentrations of Credit (November 2020).

<sup>116</sup> FRB, *Commercial Bank Examination Manual*, Section 1000.1, Examination Strategy and Risk-Focused Examinations (November 2020).

<sup>117</sup> OCC, *Comptroller's Handbook: Safety and Soundness*, Concentrations of Credit (Version 2.0, October 2020).

portion of the ACL<sup>118</sup> attributable to loans and leases, as applicable.<sup>119</sup> The FDIC's defined concentration threshold of 100 percent is 4 times higher than that established by the FRB and OCC. As a result, the FDIC approach, as compared to that of the FRB and OCC, may result in fewer concentration determinations for financial institutions that participate in Government-guaranteed loan programs.<sup>120</sup>

### ***Loan Classification***

OCC guidance issued during the course of this evaluation acknowledges that certain weaknesses identified during bank examinations could warrant an adverse classification for the conditionally guaranteed loan amount when a bank has documentation weaknesses that have been exacerbated by inadequate risk management.<sup>121</sup> It states:

In this situation, even though there may not be a payment default or SBA guaranty denial, the potential or actual documentation and risk management weakness could cause the SBA to not honor the guaranty. As a result, the potential or actual weakness could warrant a risk rating below pass. Depending on the specific facts and circumstances, the conditionally guaranteed portion could be classified substandard or worse, consistent with the risk rating of the unguaranteed portion. For example, a substandard or worse classification could be warranted if the bank is experiencing defaults in conjunction with non-compliance with SBA requirements or inadequate risk management, or if the SBA has denied liability or demanded a reduction in the guaranty payment.

OCC guidance<sup>122</sup> also states:

Credits with a U.S. government agency guarantee are usually given a pass rating. Most government guarantees are conditioned on bank management's performance (proper diligence and reporting), and mismanagement can void the guarantee and eliminate the rating

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<sup>118</sup> Per the FDIC RMS Manual, "the allowance for credit losses or ACL for loans and leases is a valuation account that is deducted from, or added to, the amortized cost basis of financial assets to present the net amount expected to be collected over the contractual term of the assets, considering expected prepayments."

<sup>119</sup> The FDIC RMS Manual requires examiners to include a written analysis on the concentrations page when an asset product line concentration is 300 percent or more of Tier 1 Capital plus the ALLL or the ACL related to loans and leases.

<sup>120</sup> FDIC examiners have the flexibility to identify concentrations at lower amounts when risk elements are present. The FDIC RMS Manual states, "[s]ound examiner judgment must be used to determine the most appropriate ROE treatment of concentrations in relation to the overall risk to the institution. Concentrations not meeting thresholds set forth in these instructions may also be included and analyzed on this page at the discretion of the Examiner-in-Charge (EIC) if elevated risk is evident or inclusion supports material examination findings."

<sup>121</sup> OCC Bulletin 2021-34, *Small Business Administration Lending: Risk Management Principles* (August 2021).

<sup>122</sup> OCC, Comptroller's Handbook, Rating Credit Risk (June 2017).

enhancement. Although the incidence of mismanagement is very low, a rating enhancement may not be appropriate for banks with significant credit administration problems affecting the guaranteed credits.

The FDIC does not have recent guidance on the treatment of Government-guaranteed loans for loan classification purposes.<sup>123</sup> However, as described above, FDIC examiners stated they would “never” classify the guaranteed portion of a Government-guaranteed loan absent direct evidence that the guaranty was in jeopardy from the administering Federal agency. This position is not consistent with the FDIC RMS Manual and OCC guidance.<sup>124</sup>

### **Recommendations:**

We recommend that the FDIC Director of RMS:

8. Revise and implement FDIC guidance and practices for assessing concentrations and loan classification to ensure uniform application with the other Federal bank regulators of supervisory approaches to banks.
9. Coordinate with the other Federal bank regulators to ensure uniform application of supervisory approaches to banks regarding concentrations and loan classification.

### **The FDIC Did Not Provide Adequate Training to Examination Staff on Government-Guaranteed Loan Programs**

The FDIC has established a dedicated program to train examination staff. However, the FDIC has not provided regular and consistent training to RMS examination staff on the requirements and potential risks of bank participation in Government-guaranteed loan programs. The GAO Standards for Internal Control in the Federal Government require that “[m]anagement recruits, develops, and retains competent personnel to achieve the entity’s objectives ... develop competencies appropriate for key roles ... and tailor training based on the needs of the role.” Further, the GAO’s

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<sup>123</sup> The FDIC issued a *Supervisory Insight on SBA lending* in 2011 that included information on loan classification. However, the *Supervisory Insight* was more than 11 years old and was not cited by FDIC management, examiners, or case managers during our assignment. The FDIC provided the OIG with the *Supervisory Insight* information after we briefed the FDIC on our preliminary evaluation results.

<sup>124</sup> According to the FDIC RMS Manual, International Section, failure by the lender to comply with a Government-guaranteed program’s conditions may allow the agency to rescind the guaranty. Documentation should be maintained for each participating transaction to show compliance with the outstanding guaranty. These documents should be scrutinized by the examiner when reviewing these credits to determine that the loan is compliant with the guaranty. Failure to comply with the terms of the guaranty may warrant adverse classification or criticism by the examiner.

Fraud Risk Management Framework recommends increasing manager and employee awareness of potential fraud schemes through training and education.

Seven of the nine RMS examiners we interviewed noted that they had not received regular or consistent training on Government-guaranteed loan programs.<sup>125</sup> For example, examiners could not recall training in the last 5 years or stated that the training was only provided in a specific region. Further, FDIC examiners have been criticized for their lack of knowledge of Government-guaranteed loan programs. During the FDIC Advisory Committee on Community Banking meeting (July 2019), a Chief Executive Officer of a bank criticized FDIC examiners about their lack of knowledge about an SBA Government-guaranteed loan program, noting that the bank officials have to provide FDIC examiners a lot of education on the SBA products and recommended that the FDIC provide training to its staff. Bank staff educating FDIC examiners about certain products places an unnecessary burden on the resources of the bank and results in inefficiencies in the examination process. In addition, FDIC examiners may be influenced or misled about Government-guaranteed loan requirements by bank officials. Examiners also may not identify or report suspicious activity without the knowledge of common or recent fraud schemes within Government-guaranteed loan programs.

In addition, the FDIC did not compile and distribute a list of examination staff experienced in these programs to the Case Managers and examiners. Therefore, FDIC examiners were not aware of the extent of FDIC examination staff with experience in examining banks that significantly participate in Government-guaranteed loan programs so they could consult with them.

FDIC officials stated that the examiners' approach to evaluating credit risk is the same regardless of whether a bank participates in Government-guaranteed loan programs. However, without specific training on Government-guaranteed loan programs, including their requirements and risks, FDIC examiners may not identify problems in a timely manner that could materially impact the conditional guarantees of Government-guaranteed loans. Such problems could include financial institutions failing to comply with program requirements for years, which may lead to the Federal agency not honoring the guaranty. If the guaranty is not honored, the bank may suffer financial losses such as reductions to capital and liquidity levels.

The FDIC Risk Inventory states that, "if FDIC does not have a training program that prepares its examiners to identify, assess, and communicate supervisory findings

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<sup>125</sup> In 2020 the SBA Office of Credit Risk Management provided training to FDIC examination staff in the New York Region on FDIC supervision over banks and SBA loan guaranty program requirements. However, this training was not provided more broadly.

and recommendations, then the FDIC's workforce may not be able to carry out effectively its supervisory responsibilities."<sup>126</sup>

Government-guaranteed loan programs have unique, evolving, and often complex requirements that banks must follow to ensure that Federal agencies honor the guarantees. For example, the SBA has made several revisions to its program requirements in the last 5 years.<sup>127</sup> Without regular training on these programs, the examiners may not be aware of the new or revised requirements that could impact loan guaranties and, ultimately, the safety and soundness of institutions.

### **Recommendations:**

We recommend that the Director of RMS:

10. Develop and implement a training plan to ensure examination staff are trained on the requirements and risks of Government-guaranteed loan programs.
11. Update, develop, and distribute to FDIC examination personnel a list of FDIC examiners who have significant experience examining banks that specialize in Government-guaranteed loan programs to regional offices.

### **The FDIC Does Not Have Adequate Data to Identify, Monitor, and Research Bank Participation in Government-Guaranteed Loan Programs**

When we asked FDIC officials about the prevalence of Government-guaranteed loans at FDIC-supervised banks, the FDIC was unable to provide basic aggregated data about the number and dollar value of Government-guaranteed loans at FDIC-supervised financial institutions. The FDIC stated that it did not regularly maintain this information.

Section 7(a) of the FDI Act authorizes the FDIC to collect information for examinations. According to the GAO Standards for Internal Control in the Federal Government, management should use quality information to achieve the entity's objective.<sup>128</sup> It further states that, "[m]anagement obtains relevant data from reliable internal and external sources in a timely manner based on the identified information requirements."

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<sup>126</sup> According to FDIC Directive 4010.3, *Enterprise Risk Management and Internal Control Program*, each FDIC Division and Office is responsible for identifying its key activities and determining what risks may threaten the FDIC's ability to achieve success. The FDIC's Chief Risk Officer and Office of Risk Management and Internal Controls maintain the Risk Inventory to capture the enterprise risks identified by the FDIC's Divisions and Offices.

<sup>127</sup> The SBA has issued four versions of its standard operating procedures for 7(a) loan program eligibility requirements since 2017. The most recent version is 590 pages.

<sup>128</sup> GAO 14-704G, *Standards for Internal Control in the Federal Government* (September 2014).

Further, FDIC supervisory examination personnel are expected to use data from the quarterly Call Report filings and other available information to monitor changes to the institution's business model, complexity, and risk profile between examinations to identify and assess risk before it impacts a financial institution's financial condition and to ensure early risk mitigation.<sup>129</sup>

The primary tool for the FDIC to collect bank data is the Call Report. However, Government-guaranteed loans are not an item listed in this report.<sup>130</sup> Between 2016 and 2017, the FDIC conducted a Small Business Lending Survey of FDIC-insured depository institutions to understand banks' small business lending practices.<sup>131</sup> The survey results informed the FDIC that the Call Report substantially understates the true amount of small business lending by banks. Further, according to the GAO, data reported by community banks do not accurately capture lending to small businesses because the data exclude some loans to small businesses.<sup>132</sup> The report stated that "the definition of small business loans used for banks' reporting excludes loans greater than \$1 million and has not been adjusted for inflation since 1992."<sup>133</sup> As a result, the Call Report does not provide adequate Government-guaranteed loan data to the FDIC for monitoring and examination activities.

During our evaluation, (b) (8) <sup>134</sup> Based on this (b) (8), from 2017 to 2021, 42 percent of FDIC-supervised financial institutions (1,281 of 3,082) approved 94,633 (b) (8) Government-guaranteed loans, totaling approximately \$66.1 billion.<sup>135</sup> As shown in Table 4, FDIC-supervised financial institutions' participation in (b) (8) Government-guaranteed loan program, increased over this time period, with a significant increase of 63 percent in total amounts approved between 2020 and 2021.<sup>136</sup>

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<sup>129</sup> OIG Report, [Offsite Reviews of 1-and 2-Rated Institutions](#) (FDIC OIG EVAL-20-002) (December 2019).

<sup>130</sup> The FDIC, in coordination with the FRB and OCC, received emergency approval to collect PPP specific data on the Call Report beginning with the June 30, 2020 reporting date. The FDIC used this information to mitigate the effects of financial institution participation in PPP when determining/calculating deposit insurance assessments. The FDIC excluded PPP loans from the institution's loan portfolio when calculating the financial institution's deposit insurance assessment rate.

<sup>131</sup> 2018 FDIC Small Business Lending Survey (December 2018).

<sup>132</sup> GAO Report, *Community Banks: Effect of Regulations on Small Business Lending and Institutions Appears Modest, but Lending Data Could Be Improved* (GAO-18-312) (August 2018).

<sup>133</sup> GAO recommended that the Chairman of the FDIC collaborate with the Federal Reserve and Office of the Comptroller of the Currency to reevaluate, and modify as needed, the requirements for the data banks report in the Consolidated Reports of Condition and Incomes to better reflect lending to small businesses.

<sup>134</sup> (b) (8)

Table 4. FDIC-Supervised Financial Institutions' Participation in (b) (8) Government-Guaranteed Loan Program

Calendar Year	FDIC-Supervised Banks	(b) (8) Government-Guaranteed Loans Approved	(b) (8) Government-Guaranteed Loan Amount	Percentage Change in Loan Amount Year Over Year	Average Loan Amount
2017	847	21,380	\$12,147,992,100		\$568,194
2018	827	19,322	\$11,437,938,500	(5.85%)	\$591,965
2019	794	16,889	\$10,919,821,700	(4.53%)	\$646,564
2020	834	15,571	\$12,012,222,900	10%	\$771,448
2021	916	21,471	\$19,584,639,700	<b>63.04%</b>	\$912,144
Totals		94,633	\$66,102,614,900		

Source: (b) (8).

While this information had been obtained by the FDIC Division of Insurance and Research (DIR) for research-related purposes and studies, it was not shared with other FDIC Divisions, such as the ones conducting the bank examinations, RMS and DCP. In addition, FDIC examiners we interviewed were not aware that this data existed, and as described above, did not request or require that banks identify Government-guaranteed loans in their loan data submissions to the FDIC during the examination planning phase.<sup>137</sup>

In June 2019,<sup>138</sup> RMS and (b) (8) entered into an MOU ((b) (8) MOU) to enhance the exchange of information related to FDIC-supervised banks that substantially participate in the (b) (8). However, the (b) (8) MOU omits any provision to facilitate the sharing of (b) (8) Government-guaranteed loan portfolio information with the FDIC. In addition, RMS did not enter into agreements to facilitate information sharing with other Federal agencies that administer Government-guaranteed loan programs.

Absent sufficient data, the FDIC may be limited in its ability to proactively identify and monitor emerging risks associated with a bank's participation in Government-guaranteed loan programs. Therefore, the FDIC is not able to conduct research into bank portfolio segments that Government-guaranteed loans support, such as small and agricultural businesses.

<sup>137</sup> FDIC OIG informed RMS of this (b) (8) data during our evaluation to assist them with bank research, monitoring, planning, and examination activities.

<sup>138</sup> (b) (8)

### Recommendations:

We recommend that the Director of RMS, in coordination with the Director of DIR:

12. Develop and implement a process to obtain improved data regarding Government-guaranteed lending activities of FDIC-supervised financial institutions.
13. Update the (b) (8) MOU to include the sharing of loan portfolio information such as historical loan performance, status of guaranty, and loan-level risk characteristics.
14. Establish arrangements with other Federal agencies that administer Government-guaranteed loan programs to facilitate information sharing and proactive identification of risk.

### The FDIC Did Not Effectively Share Information on Government-Guaranteed Loan Programs Externally and Internally

#### *External Information Sharing*

The FDIC did not effectively share information with other Federal agencies or ensure that it obtained relevant information from Federal agencies regarding banks that participate in Government-guaranteed loan programs. The GAO Standards for Internal Control require management to communicate with and obtain quality information from external parties, including government entities. This information includes significant matters relating to risks and changes in or issues that impact an entity's internal control system.<sup>139</sup> Guidance issued by the SBA demonstrates the need for sharing information with and receiving information from other Federal bank regulators, such as the FDIC to promote effective oversight. The guidance states that "the extent of monitoring, [i]ncreased [s]upervision and [e]nforcement will depend upon the type of SBA Participant overseen, e.g., SBA Supervised Lender[s] versus 7(a) Lenders regulated by Federal Financial Institution Regulator[s], and the extent to which SBA may rely on or coordinate oversight with a Participant's primary federal regulator."<sup>140</sup>

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<sup>139</sup> GAO 14-704G, *Standards for Internal Control in the Federal Government* (September 2014).

<sup>140</sup> SBA SOP 50 53 (2), *Supervision and Enforcement* (January 2021).

Regarding the FDIC sharing data with other agencies, the FDI Act authorizes the FDIC in the discretion of the agency:

To furnish any report of examination or other confidential supervisory information concerning any depository institution to any other Federal agency with “regulatory authority over the depository institution” or to any other person that the FDIC determines to be appropriate.<sup>141</sup>

The FDIC’s regulatory authority allows the Director of RMS, in the Director’s discretion and for good cause, to disclose reports of examination or other confidential supervisory information to such entities.<sup>142</sup>

In addition, the FDIC Case Manager Procedures state that:

In order to properly assess risk, the Case Manager must maintain an informed position on their caseload through review of reports of examination and correspondence; processing of applications; review of press releases and other media sources; consideration of exception reports generated by offsite monitoring systems; and communication with regulatory counterparts and financial institution officials.<sup>143</sup>

As noted above, the FDIC RMS and (b) (8) entered into an MOU to enhance the exchange of information related to FDIC-supervised financial institutions that substantially participate in the (b) (8). The (b) (8) MOU

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provided (b) (8) to RMS in accordance with the (b) (8) MOU. As previously noted, RMS also did not enter any other similar information sharing agreements with other Federal agencies that administer Government-guaranteed loan programs.

FDIC Case Managers and examiners often did not contact other Federal agencies (that is, (b) (8), or other Government agencies guarantying loans) to obtain direct and independent information about the financial institution that may influence the approach in conducting examinations. The nine

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<sup>141</sup> Section 7(a)(2) of the Federal Deposit Insurance Act; 12 USC 1817(a)(2) (2018).

<sup>142</sup> 12 C.F.R. § 309.6(b)(3) (2021).

<sup>143</sup> FDIC Case Manager Procedures, Case Manager Overview (February 2021).

<sup>144</sup> (b) (8)

FDIC examiners we interviewed did not contact the Federal agencies to obtain information about the financial institutions. The examiners noted that such communication would likely occur at a higher level above examination field staff. However, only one of the three Case Managers we interviewed communicated with a Federal Agency that administers Government-guaranteed loans about two problem banks. As described below, the FDIC has not established a process for regular engagement with Federal agencies that administer Government-guaranteed loan programs.

We previously issued a Management Advisory Memorandum to the FDIC regarding our concerns about its communication with a Federal Government Agency that administered a Government-guaranteed loan program.<sup>145</sup> The Federal Government Agency identified that Bank 2 and a third party charged impermissible fees to loan applicants. The FDIC did not effectively coordinate with the Federal Government Agency to obtain relevant information in order to assess the impact that the impermissible fees had on the bank's safety and soundness and consumer protection compliance. Instead, the FDIC recommended that Bank 2, deemed to be in unsatisfactory condition, coordinate further with the Federal Government Agency for resolution. We conservatively estimated that the prohibited fees charged to the borrowers amounted to at least \$7.2 million. (b) (8)

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Further, the FDIC did not notify the SBA of issues it identified with an FDIC-supervised institution that participated in the PPP. As highlighted previously in this Report, (b) (8)

. However, the FDIC did not notify the SBA of issues that the FDIC had identified with respect to (b) (8) either before, during, or after the time that it heavily participated in the SBA's PPP.

In response to our questions on how FDIC examination activities and results could assist the SBA in overseeing bank participation in SBA loan programs, SBA officials stated that:

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<sup>145</sup> OIG Memorandum, [Impermissible Fees Charged by an FDIC-Regulated Bank](#) (FDIC OIG AEC Memorandum 22-001) (December 2021).

<sup>146</sup> (b) (8)

[i]f an [Federal Financial Institution Regulator] examination identifies that an institution lacks credit risk management, servicing, and/or liquidation capabilities and has an impaired financial condition, it would be helpful for the [Federal Financial Institution Regulator] to inform the SBA early on so that SBA could assess the impact of this issue on the SBA operation and loan portfolio performance. In addition, it would be helpful if an [Federal Financial Institution Regulator] shared with SBA information on informal enforcement activities.<sup>147</sup>

The FDIC did not establish procedures for Case Managers or examiners to contact (b) (8) concerning institutions listed on the (b) (8) during the FDIC examination planning or execution process. Such communications would enable the FDIC to obtain pertinent Federal agency Government-guaranteed loan program information (for example, risk ratings, oversight review results, concerns on the institutions portfolio or practices, information on denials of guaranteed portions of loans, etc.). FDIC officials noted that the FDIC does not expect examiners to coordinate with or contact other Federal agencies that administer Government-guaranteed loan programs. FDIC officials specified that it would be rare for an examiner to call other Federal agencies that do not have a safety and soundness mandate under the FDI Act without first going through regional management.

Effective communication of (b) (8) to another Federal agency with respect to (b) (8) could have resulted in heightened scrutiny or limitations applied to the bank's PPP lending activities in an effort to mitigate fraud risk.

In response to the Management Advisory Memorandum discussed above, FDIC officials noted that other Federal Government Agencies that administer Government-guaranteed loan programs are subject to their own confidentiality restrictions. They stated that any engagement between the FDIC and those agencies would require an MOU between the agencies or a formal request for disclosure pursuant to the access policy of the agency receiving an access request. FDIC officials also stated that sharing confidential information, including confidential supervisory information, protected by

Effective coordination with another Federal agency for Bank 2 could have resulted in the timely identification of at least \$7.2 million in impermissible fees charged to the borrowers. This would have been relevant to the FDIC's supervision of the bank's safety and soundness and the potential for consumer harm.

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<sup>147</sup> (b) (8)

law or regulation from disclosure would not be a routine practice. However, as described above, the FDIC has legal authority<sup>148</sup> to share confidential supervisory information, at its discretion and for good cause, with another Federal agency with regulatory authority over a financial institution, subject to compliance with other applicable law.

Effective coordination with other Federal agencies that maintain relevant information about loans at financial institutions is critical in order to obtain and communicate about the financial institution under review, including Government-guaranteed loan risks. Absent such coordination, FDIC examiners may not be aware of, or able to proactively address, emerging risks in financial institutions that significantly participate in Government-guaranteed loan programs. Conversely, Federal agencies that administer Government-guaranteed loan programs may not be aware of risks to their programs identified by FDIC personnel.

In addition, without regular communication with other Federal agencies, FDIC examiners may not become aware of, identify, understand, or communicate the significance of deficiencies or concerns that could impact examination approaches, scoping, testing, or considerations for safety and soundness and consumer harm.

### ***Internal Information Sharing***

The FDIC did not effectively share information internally regarding banks that participated significantly in Government-guaranteed loan programs. The FDIC RMS Manual states, “[i]n order for examiners to proactively assess potential deficiencies, it is critical for field supervisors and other personnel to be aware of, and have access to, pertinent documentation.” According to the GAO Standards for Internal Control in the Federal Government, effective internal control requires that “[m]anagement communicates quality information down and across reporting lines to enable personnel to perform key roles in achieving objectives, addressing risks, and supporting the internal control system.”<sup>149</sup>

As noted above, the (b) (8) lists in 2019 and 2021 to RMS in accordance with the (b) (8) MOU. According to FDIC officials, FDIC examiners would be expected to request or require a bank to disclose detailed information on the Government-guaranteed lending activities if a bank was included on the (b) (8) list. We reviewed four banks (Bank 2, Bank 3, Bank 4, and Bank 5), that were all on the (b) (8) list provided under the (b) (8) MOU. However, FDIC bank examination staff whom we interviewed, including two Case Managers and eight examiners, either were unaware of, or had

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<sup>148</sup> Section 7(a)(2) of the Federal Deposit Insurance Act; 12 USC 1817(a)(2) (2018).

<sup>149</sup> GAO 14-704G, *Standards for Internal Control in the Federal Government* (September 2014).

not seen, either the (b) (8) MOU or the (b) (8) lists. As a result, FDIC Case Managers and examiners did not know that (b) (8) had identified increased risks at FDIC-supervised institutions based (b) (8)

150

In addition, the (b) (8) MOU provides that the FDIC and (b) (8) meet semi-annually to discuss items of mutual interest relating to (b) (8), (b) (8), and other relevant information. The FDIC and (b) (8) met several times between (b) (8).

However, the FDIC did not maintain minutes for some of these meetings. Therefore, the examiners and Case Managers may not be (1) aware that (b) (8) identified (b) (8) factors for certain FDIC-supervised banks; (2) aware that the MOU facilitated the sharing of information on (b) (8); or (3) informed of relevant information discussed during these meetings. Further, information from these coordination meetings could also inform the Division of Depositor and Consumer Protection (DCP) of risks to consider during examinations of banks' compliance with the requirements of Federal consumer protection laws and regulations. However, DCP staff were unaware of the MOU and the (b) (8) list. Similarly, such coordination information could inform the DIR<sup>151</sup> to assist in identifying and analyzing emerging risks.

Staffing changes affected the FDIC's oversight and management of the (b) (8) MOU. In addition, the FDIC had not distributed the (b) (8) MOU and related (b) (8) list to all examination staff having a need for the information to assist in monitoring, planning, and examination execution. During the course of our evaluation, the FDIC established a new point of contact for the (b) (8) MOU (the RMS Senior Deputy Director) and stated it would place the (b) (8) list on an internal collaboration platform.

Sharing information internally within the FDIC regarding financial institutions that participate significantly in Government-guaranteed lending programs is critical in order to understand the underlying risks present at these institutions. Absent such information, FDIC examiners and Case Managers may not identify or understand the significance of deficiencies or concerns that could impact examination approaches, scope considerations, or testing.

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<sup>150</sup> (b) (8)

<sup>151</sup> FDIC DIR provides comprehensive statistical information on banking. It, among other things, identifies and analyzes emerging risks, and conducts research that supports deposit insurance, banking policy, and risk assessments.

### Recommendations:

We recommend that the FDIC Director of RMS:

15. Develop and implement processes and procedures for the routine sharing, receipt, and storage of confidential information with Federal agencies that administer Government-guaranteed loan programs.
16. Develop and implement guidance to provide instruction to FDIC bank examination staff requiring communication and information sharing with Federal agencies that administer Government-guaranteed loan programs to ensure FDIC staff and the Federal agencies are aware of any emerging risks.
17. Determine whether other Federal agencies that administer Government-guaranteed loan programs have a list of FDIC-supervised banks with high risk factors associated with such programs and develop protocols to share information with relevant FDIC personnel, including examiners.
18. Develop and implement guidance to ensure relevant risk information exchanged with Federal Government agencies that administer Government-guaranteed loan programs is shared internally within the FDIC on an ongoing basis with the appropriate FDIC employees.

### The FDIC's Examination Guidance Lacked Instructions on the Retention of Examination Workpapers

Supervisory workpapers related to RMS's examination of financial institutions' participation in PPP were added to the Regional Automated Document Distribution and Imaging System (RADD), the official recordkeeping system for FDIC supervisory business records,<sup>152</sup> subsequent to our evaluation of RADD and our formal request for such evidence.

Workpapers describe the work performed during RMS examinations of financial institutions and include detailed information such as test procedures and results, risks, control weaknesses, and support for findings. In addition, workpapers from previous examination cycles are important resources for examiners when conducting their examination planning activities. According to FDIC procedures, examiners

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<sup>152</sup> FDIC Directive 6000.1, *Electronic Supervisory Business Records* (July 2019).

exercise discretionary judgment in determining which electronic workpapers are to be retained in RADD at the conclusion of an examination or visitation.<sup>153</sup>

According to FDIC policy, retained documents should support examination and verification procedures performed, conclusions reached, and assertions of fact or opinion detailed in Reports of Examination or other supervisory findings.<sup>154</sup> FDIC policy further requires that:

- All RMS and DCP workpapers supporting examinations should be retained in an electronic format unless hardware or technical issues require hard copies;
- Examiners should manage and store electronic documents using the Electronic Workpapers (EWP) Module in RADD, which is referred to as RADD-EWP; and
- Examiners should scan hardcopy documents in a secure location within a *reasonable time* after receiving or developing them.

FDIC officials defined reasonable time as “the time between receiving a hard copy document and the time when the document is scanned in.” The definition provided by RMS did not disclose an adequate or quantitative measure of time that is reasonable or necessary to scan hardcopy documents. The FDIC was unable to provide any other guidance that defined a specific timeframe within which supervisory workpapers are to be uploaded to RADD.

As noted in Table 3 above, we evaluated FDIC examination of PPP related activities for eight FDIC-supervised financial institutions. Supervisory workpapers related to the FDIC’s supervision for four of the eight sampled financial institutions, or 50 percent, were not in RADD at the time of our review or were imported into RADD subsequent to the OIG’s request for information.

- **Bank 1:** The FDIC had concluded its examination of Bank 1 in (b) (8) [REDACTED]. As of April 2021, the FDIC had not input any documents in RADD involving RMS’s examination of Bank 1’s participation in PPP. In (b) (8) [REDACTED] the FDIC added supervisory workpapers to RADD related to its review of the bank’s participation in the PPP, which was approximately 5 months after the conclusion of the examination.

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<sup>153</sup> FDIC RD Memo No. 2019-014-RMS and 2019-005-DCP, *Regional Automated Document Distribution and Imaging System* (July 16, 2019). According to the RD Memo, RADD is the official recordkeeping and electronic filing system for supervisory business records for RMS and DCP. It also states that “SOURCE remains a system of record for compliance and CRA examination activities.”

<sup>154</sup> FDIC RD Memo No. 2013-008-RMS and 2013-010-DCP, *Scanning Policy for Electronic Workpaper Documentation* (September 2013).

- **Bank 5:** The FDIC had concluded its examination of Bank 5 in (b) (8). However, the FDIC only provided evidence for its examination of PPP loans in February 2022, upon our request.
- **Bank 8:** In (b) (8), the FDIC examined Bank 8's participation in PPP and issued a targeted review letter in (b) (8).<sup>155</sup> The FDIC added supervisory workpapers to RADD in (b) (8), approximately 6 months after the issuance of the targeted review letter.
- **Bank 9:** The FDIC conducted an ongoing monitoring review of the bank's PPP loan participation during the period (b) (8).<sup>156</sup> The FDIC added the examiner conclusion memorandum for this review to RADD in (b) (8), approximately 1 year after the conclusion of the review.

FDIC officials acknowledged that certain key examination related to participation in PPP had been missing from RADD. In addition, from 2017 to 2020, RMS's Internal Control Review Section published reports for all six FDIC regions and highlighted similar concerns about deficiencies in RADD recordkeeping. These reports found that certain supporting documentation -- such as supervisory program documentation, supervisory recommendation logs, and ongoing monitoring reports -- was incomplete or missing in RADD, and in some cases, supporting documentation was found in the wrong folders.

Maintaining complete and timely examination records in RADD supports the FDIC's ability to effectively manage and oversee its examination process. Although the FDIC maintains separate repositories for the records of institutions under the continuous examination program, this information should be timely documented in RADD. Inconsistencies in recordkeeping practices and the lack of complete documentation hinders the ability for auditors to conduct reviews of RMS examination activities and limits the transparency and accountability of examination operations. Additionally, FDIC examiners and state banking examiners may not have access to all relevant information when reviewing workpapers from previous examinations.

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<sup>155</sup> Bank 8 is a large institution and under the continuous examination process. The continuous examination process includes targeted reviews of certain areas of bank operations. The FDIC issues a target review letter to the bank at the conclusion of each targeted review.

<sup>156</sup> Bank 9 is a large institution and under the continuous examination process. Ongoing monitoring reviews are performed throughout the examination cycle, or planned and completed for a specific purpose. Examiners use the combination of targeted reviews and ongoing monitoring reviews throughout the examination cycle to determine and support the results presented in the ROE.

### Recommendations:

We recommend that the FDIC Director of RMS:

19. Develop and implement updated FDIC examination guidance to establish an appropriate timeframe for uploading complete supervisory business records to RADD.

### Conclusion

FDIC banks regularly participate in Government-guaranteed loan programs, with some originating billions of dollars in Government-guaranteed loans. FDIC financial institutions have realized risk from applying imprudent banking practices or perpetrating fraud in Government-guaranteed loan programs. Such activities contributed to the failure of multiple financial institutions. Further, these failures resulted in estimated losses to the FDIC DIF of over \$140 million. It is important that the FDIC proactively identifies and addresses risks for financial institutions that participate in Government-guaranteed loan programs, before they result in consumer harm or significant fraud. Until the FDIC addresses the weaknesses presented in this Report, there is an elevated risk that the safety and soundness of financial institutions participating in Government-guaranteed loan programs may deteriorate, leading to bank failure or consumer harm and ultimately increased risk or loss to the DIF.

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## FDIC COMMENTS AND OIG EVALUATION

On April 21, 2023, the FDIC Director of RMS provided a written response to a draft of this report. The response is presented in its entirety in Appendix 7.

In its response, the FDIC acknowledged that it has limited guidance for examiners on Government-guaranteed loan activities and that Government-guaranteed loans present risks to FDIC-insured and FDIC-supervised institutions if conducted without proper due diligence and risk management. However, the FDIC believes its guidance was sufficiently detailed to allow examiners and Case Managers to address risks in certain areas.

The FDIC also stated that it disagreed with certain findings within the draft report. While the FDIC's response did not acknowledge the significance of our results, we note that the FDIC concurred or partially concurred with all 19 recommendations and proposed sufficient corrective actions that will significantly improve FDIC examinations and FDIC coordination with other Federal agencies. Furthermore, the FDIC's criticisms of our findings mainly focused on two of our eight findings,

demonstrating that the FDIC agreed with a substantial majority of our findings and conclusions.

While the FDIC acknowledged that its guidance for determining concentration thresholds differed from the OCC and FRB guidance, the FDIC dismissed our results and rationale that a higher concentration threshold may result in fewer concentrations being identified and analyzed. The FDIC acknowledged its higher concentration threshold of 100 percent of Tier 1 Capital plus the ALLL or the ACL related to loans and leases for listing loan product concentrations and explained that examiners are required to provide written analytical comments for concentrations at or exceeding 300 percent. We continue to support the position expressed in our report that a concentration threshold that is 4 times higher than that established by the FRB and OCC (100 percent vs. 25 percent) may decrease the potential for FDIC examiners to identify, list, and address potential risks for concentrations.

The FDIC's response also mischaracterized segments of our draft report. The FDIC stated that we acknowledged within the report the FDIC's risk-focused approach to supervision, but then contradicted that philosophy in presenting a formulaic approach. This is not accurate. Rather, our findings demonstrated that, in alignment with the FDIC's risk-focused approach to supervision, certain institutions should have received additional transaction level testing due to their higher exposure to risks related to Government-guaranteed loans and observed areas of noncompliance. Our report presented examples where banks with a higher level of risk due to their Government-guaranteed loan exposure or BSA/AML weaknesses either did not receive transaction testing or received less than that of banks with less risk exposure. Therefore, we did not favor a formulaic or one-size-fits all approach as suggested by the FDIC. The FDIC also took exception with our findings on concentration risks related to Government-guaranteed loans. However, our findings demonstrated the different ways that examiners considered concentration risk in order to emphasize the need for improved guidance to ensure consistency. In addition, guidance from the other Federal regulators emphasizes the consideration of off-balance sheet risk items when determining and calculating concentrations.

The FDIC stated it disagreed with our interpretations and proposed applications of U.S. Generally Accepted Accounting Principles (GAAP) outlined in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 450-20, Loss Contingencies. The FDIC also disagreed with our suggestion that examiners have more latitude than the FDIC believes is prescribed in accounting guidance. We found that the FDIC RMS Manual neither described how examiners should assess the off-balance sheet risks associated to sold portions of Government-guaranteed loans, nor articulated how examiners should coordinate with internal experts or other Federal agencies that administer Government-guaranteed to

determine whether contingent liabilities should be established. We acknowledge in our report that assessing off-balance sheet risk requires judgment and an interpretation of accounting standards. Absent such guidance, we reiterate our interpretations that FDIC examiners could have recommended that banks disclose the possible losses or considered the sold portions of the classified loans as contingent liabilities. The FDIC's response also stated that we suggested the FDIC establish guidance for FDIC examiners to require banks to accrue a contingent liability when a future event is possible rather than probable in contradiction of GAAP. This is simply not accurate. Rather, our finding demonstrated that there is not a black and white interpretation of the terms "probable" and "reasonably estimable" in order to persuade the FDIC to establish guidance for examiners to guide them in making such determinations. Significantly, the FDIC concurred with our recommendation to develop and implement guidance to examination staff to ensure they consistently evaluate Government-guaranteed loans in their assessment of off-balance sheet risk.

The FDIC stated it believes its examiners assessed Government-guaranteed loan program requirements consistent with risk-focused supervision principles. However, as detailed in our report, and contrary to the requirements and expectations established in the FDIC RMS Manual, we found that FDIC examiners did not test Government-guaranteed loans against program requirements for certain banks. As cited in our report, the FDIC RMS Manual states "in all instances, examiners should sample enough credits, including new and various-sized credits, to assess the adequacy of asset quality, underwriting practices, and credit risk management, in order to support ROE findings and assigned ratings." It further states "[t]ransaction testing remains a reliable and essential examination technique for use in the assessment of a bank's condition." Given the prolific Government-guaranteed loan activity of the banks we reviewed, we believe testing such loans against program requirements was warranted in compliance with the FDIC RMS Manual in order for the FDIC to make adequate assessments of the banks' asset quality and underwriting.

In addition, the FDIC believes it treated the guaranteed portion of Government-guaranteed loans appropriately when assigning classifications and claims that the issues outlined by the OIG in this report with respect to examiners' treatment of the guaranteed portion of loans (on-balance sheet) was solely based on hazardous lending practices by banks. As detailed in our report, examiners adversely classified the unguaranteed portion of loans but did not adversely classify the guaranteed portion of those same loans, considering them a "Pass." In the case of Almena State Bank, the FDIC rated the bank's management as "critically deficient", which represented the highest degree of supervisory concern, while also identifying hazardous underwriting and significant loan administration weaknesses. We believe

that considering the guaranteed portions of loans as “Pass” and not rating them as “Substandard” or worse was not appropriate for certain Government-guaranteed loans originated by Almena State Bank given the weaknesses identified by the FDIC. In addition, the FDIC’s position on the guaranteed portion of such loans appears to differ from credit risk rating guidance established by the OCC, which supports that a rating enhancement<sup>157</sup> for Government-guaranteed loans may not be appropriate for banks with significant credit administration problems affecting the guaranteed credit.

The FDIC concurred with 13 recommendations and partially concurred with the remaining 6 recommendations, offering acceptable alternative actions. The FDIC plans to complete corrective actions for these recommendations by March 31, 2024. We consider all 19 recommendations to be resolved.

All of the recommendations in this report will remain open until we confirm that corrective actions have been completed and the actions are responsive. A summary of the FDIC’s corrective actions is contained in Appendix 8.

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<sup>157</sup> A rating enhancement represents a more favorable loan classification. This may include considering the guaranteed portions of loans with identified weaknesses as “Pass.”

## Objective

Our evaluation objective was to determine the effectiveness of the FDIC's examinations in identifying and addressing risks related to Government-guaranteed loans for banks that participate in Government-guaranteed loan programs.

We conducted this evaluation from June 2021 through December 2022 in accordance with the Council of the Inspectors General on Integrity and Efficiency *Quality Standards for Inspection and Evaluation* (issued January 2012).<sup>158</sup>

## Scope and Methodology

The scope of our evaluation focused on FDIC safety and soundness examinations of FDIC-supervised financial institutions that participated in Government-guaranteed loan programs.

To address our evaluation objective we:

- Interviewed RMS, DCP, and the Division of Insurance and Research personnel to obtain an understanding of bank supervision and data collection activities related to financial institutions that participate in Government-guaranteed loan programs.
- Interviewed FDIC Legal Division personnel and obtained information from them to understand legal proceedings related to financial institutions' participation in Government-guaranteed loan programs and the FDIC's authority to share confidential supervision information with other Federal agencies.
- Interviewed personnel from the FDIC OIG Office of Investigations to obtain an understanding of fraud investigations involving Government-guaranteed loan programs.
- Interviewed personnel from the OCC and FRB to obtain an understanding of their supervision activities related to financial institutions that participate in Government-guaranteed loan programs.
- Obtained and reviewed information from the (b) (8) on its oversight of FDIC-supervised financial institutions that participate in (b) (8) Government-guaranteed loan programs.
- Reviewed FDIC and other Federal regulator criteria related to the financial institution examination process.

<sup>158</sup> In December 2020 the Council of the Inspectors General on Integrity and Efficiency issued an update to the *Quality Standards for Inspection and Evaluation* which is effective for all inspections and evaluations beginning on or after January 1, 2022. Because we initiated this evaluation in June 2021, we adhered to the January 2012 standards.

- Reviewed criteria related to the PPP.
- Reviewed the GAO's Standards for Internal Control in the Federal Government and GAO's Fraud Risk Management Framework.
- Reviewed RMS Internal Control and Review Section Regional Reports for the Atlanta, Kansas City, Dallas, New York, Chicago, and San Francisco regions.
- Reviewed the FDIC's Risk Profile and Risk Inventory to determine if there were any Agency risks related to the objective.
- Reviewed Government-guaranteed loan program requirements and financial institution oversight for the SBA, U.S. Department of Agriculture, U.S. Department of Veterans Affairs, and U.S. Department of Housing and Urban Development.
  - This included the Federal agencies' standard operating procedures and regulations for the various Government-guaranteed loan programs.
- Selected and reviewed RMS examination activities for the below four FDIC-supervised financial institutions that participated in Government-guaranteed loan programs.
  - Almena State Bank: We selected this bank because it failed in part due to hazardous Government-guaranteed lending.
  - Bank 3, Bank 4, and Bank 5: We selected these banks because they were identified on the (b) (8) list with (b) (8)
- Reviewed FDIC examination activities for Bank 2, which was under enforcement actions related to its participation in a Government-guaranteed loan program.
- Selected and reviewed RMS examination activities for Bank 1 due to the bank's significant participation in the PPP.
- Reviewed RMS examination activities related to only the PPP for the following five FDIC-supervised financial institutions:
  - Bank 9, Bank 10, Bank 6, Bank 8, and Bank 7.
- Reviewed prior Federal OIG audit and evaluation reports related to the supervision of financial institutions that engage in Government-guaranteed loan programs and for Agencies that administer Government-guaranteed loan programs.
- Analyzed (b) (8) portfolio data to determine FDIC-supervised financial institutions' level of participation in the (b) (8).

159

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<sup>159</sup> We also considered the supervisory activity in the FDIC's regions during our selection to ensure a representation across the FDIC regional offices.

- We relied on an OIG Senior Information Technology Specialist to analyze the FDIC's public list of FDIC-insured financial institutions<sup>160</sup> and (b) (8) [REDACTED]<sup>161</sup>.
- Utilized non-public PPP loan data maintained by the PRAC to determine FDIC-supervised financial institutions' level of participation in the PPP loan program.
  - We relied on an OIG Senior Information Technology Specialist to analyze the PPP loan data<sup>162</sup> we received from the PRAC and associate information to FDIC-insured financial institutions.

(b) (8) [REDACTED]

<sup>162</sup> We analyzed PPP data as of August 31, 2022.

<b>ACL</b>	Allowance for Credit Losses
<b>ALLL</b>	Allowance for Loan and Lease Losses
<b>AML</b>	Anti-Money Laundering
<b>BSA</b>	Bank Secrecy Act
<b>CARES Act</b>	Coronavirus Aid, Relief, and Economic Security Act
<b>CAMELS</b>	<b>C</b> apital Adequacy, <b>A</b> sset Quality, <b>M</b> anagement Capabilities, <b>E</b> arnings Sufficiency, <b>L</b> iquidity Position, and <b>S</b> ensitivity to Market Risk
<b>CEO</b>	Chief Executive Officer
<b>COVID-19</b>	Coronavirus Disease 2019
<b>CRA</b>	Community Reinvestment Act
<b>DCP</b>	Division of Depositor and Consumer Protection
<b>DIF</b>	Deposit Insurance Fund
<b>DIR</b>	Division of Insurance and Research
<b>EPS</b>	Examination Profile Script
<b>EWP</b>	Electronic Workpapers
<b>FDI Act</b>	Federal Deposit Insurance Act
<b>FDIC</b>	Federal Deposit Insurance Corporation
<b>FFIEC</b>	Federal Financial Institutions Examination Council
<b>FY</b>	Fiscal Year
<b>FRB</b>	Board of Governors of the Federal Reserve System
<b>GAO</b>	Government Accountability Office
<b>LIDI</b>	Large Insured Depository Institution
<b>MOU</b>	Memorandum of Understanding
<b>MRBA</b>	Matter Requiring Board Attention
<b>OCC</b>	Office of the Comptroller of the Currency
<b>OIG</b>	Office of Inspector General
<b>PPP</b>	Paycheck Protection Program

<b>PRAC</b>	Pandemic Response Accountability Committee
<b>RADD</b>	Regional Automated Document Distribution and Imaging System
<b>RD Memo</b>	Regional Directors Memorandum
<b>RMS</b>	Division of Risk Management Supervision
<b>ROE</b>	Report of Examination
<b>SBA</b>	Small Business Administration

In August 2021, the OCC issued a bulletin highlighting the various risks associated with SBA guaranteed lending activities.<sup>163</sup> The bulletin identified and described the following risks:

- **Credit Risk:** Borrowers eligible for SBA programs typically lack adequate credit or cash flow history or have weak collateral. There is credit risk on the guaranteed and unguaranteed portions<sup>164</sup> of SBA loans that banks hold. The SBA may not honor the guaranty if the bank does not comply with SBA's requirements, causing a loss to the bank when the borrower defaults on its loan payments.
- **Operational and Compliance Risks:** Securing an SBA guaranty requires significant documentation and administration efforts by the originating bank. SBA approved lenders are also required to service their entire SBA loan portfolios, including the portions they have sold.<sup>165</sup> SBA may deny its guaranty for, among other things, inadequate documentation, inappropriate loan modifications, inadequate analysis of the borrower's ability to repay the loan, and impermissible use of loan proceeds. Further, banks contracting with third parties to assist with SBA lending processing can introduce additional operational risk. The banks retain responsibility for originating, closing, servicing, and liquidating their SBA portfolio when using third parties.
- **Liquidity and Price Risks:** If a bank relies on selling SBA loans to meet liquidity needs and gets suspended or prohibited from selling SBA-guaranteed loans in the secondary market due to material noncompliance with SBA's requirements, it can significantly impact its liquidity. Specifically, in such circumstances, the bank will no longer realize income to increase liquidity from selling assets on the secondary market. In addition, banks that depend on selling SBA-guaranteed loans for earnings face price risk when premiums decline or loan holding periods increase.
- **Strategic Risk:** Banks that engage in new, expanded, or modified SBA lending activities are exposed to strategic risk. Market demand changes could make the activity no longer economical.

<sup>163</sup> OCC Bulletin 2021-34, *Small Business Administration Lending: Risk Management Principles* (August 2021).

<sup>164</sup> The unguaranteed portion represents the amount of the loan not covered by the SBA guaranty. For example, if the SBA offers a 75 percent guaranty on a \$1 million loan, the unguaranteed portion is \$250,000 ( $\$1,000,000 \times .25$ ).

<sup>165</sup> The SBA allows banks to sell the guaranteed portion of SBA loans to investors on the secondary market for a premium.

This table presents a sample of criminal investigations related to Government-guaranteed loan programs.

Department of Justice Press Release	Investigation Summary <sup>166</sup>	Estimated Fraud Amount <sup>167</sup>
<a href="#">Jury Convicts Five Former Officers and Employees of Banc-Serv Partners in \$5 Million Scheme to Defraud the Small Business Administration</a>	<p>According to the evidence presented at trial, the defendants — Kerri Agee, 46, former president, chief executive officer and founder of Banc-Serv; Kelly Isley, 40, Banc-Serv’s former chief operating officer; Nicole Smith, 44, Indiana, a former Banc-Serv employee; Chad Griffin, 48, Banc-Serv’s former chief marketing officer; and Matthew Smith, 52, of Westfield, Indiana, Banc-Serv’s co-founder and a former director of a lending institution that originated loans with Banc-Serv — fraudulently obtained SBA-guaranteed loans on behalf of their clients, knowing that the loans did not meet SBA’s guidelines and requirements for the guarantees. The evidence at trial proved that from approximately 2004 until October 2017, the defendants helped originate SBA loans on behalf of various financial institutions and other lenders and, on multiple occasions, fraudulently obtained guarantees for loans that the SBA had deemed ineligible. They did so by, among other things, knowingly misrepresenting what the loans would be used for and unlawfully diverting previously denied loan applications into expedited approval channels at the SBA. When the fraudulently guaranteed loans defaulted, the defendants caused the submission of the reimbursement requests to the SBA to purchase the defaulted loans from investors and lending institutions, thereby shifting some of the losses on the ineligible loans to the SBA.</p> <p>The fraudulent loans presented at trial totaled approximately \$5 million in guaranteed disbursements, which were not eligible for SBA guarantees.</p>	\$5,000,000
<a href="#">French National Indicted For Six Million Dollar Bank Fraud Scheme and for Lying In an Application for U. S. Government Insured Loans</a>	<p>A man was indicted in for his role in a bank fraud scheme including lying in an application for Government-guaranteed loans. Three banks were targeted in two separate schemes involving inflated inventory as collateral on the loans. The defendant provided inflated undocumented estimates of his inventory to an appraiser he had hired. The indictment alleges that the inventory appraised for \$21 million in 2007, was sold for \$64,000 in 2010, leaving no collateral on the loan. The defendant then submitted an inflated and fraudulent loan guarantee application with the U.S. Department of Agriculture for a \$3 million loan from a bank in Texas. The defendant defaulted on this loan in 2009, causing a \$900,000 loss to the Texas bank, which forced the U.S. Department of Agriculture</p>	\$4,000,000

<sup>166</sup> Source: Department of Justice, United States Attorney’s Office, Press Releases (Various Districts).

<sup>167</sup> These figures include the amounts related to submission of fraudulent loan applications, loan disbursements, fees generated, or loss to the financial institution.

	<p>to cover the guaranteed portion of the loan listed at \$2,107,259. In March of 2009, the defendant sought from a bank in New Orleans an additional guaranteed loan from the SBA for a separate business entity that he controlled. The defendant again, over-inflated inventory appraisals and collateral levels to obtain the \$1 million loan that later resulted in default. The SBA paid the New Orleans bank \$774,041 to honor the guarantee and the bank suffered an approximate \$225,000 loss on the loan.</p>	
<p><a href="#">Bank CEO Convicted For Taking Bribes In Connection With Loans Guaranteed By The Small Business Administration</a></p>	<p>The CEO of a Pennsylvania-based Bank (The Bank), was convicted for taking bribes in connection with the Bank’s issuance of loans that were guaranteed by the SBA. The CEO was arrested in May of 2019 and charged with taking bribes by siphoning off a portion of commissions on SBA-guaranteed loans and causing the Bank to issue SBA-guaranteed and commercial loans to companies in which Shin had a secret interest. The CEO secretly solicited and received bribe payments in connection with SBA-guaranteed loans issued by the Bank. Specifically, when the Bank issued business loans that did not involve the use of any actual broker, the CEO nonetheless arranged to have his longtime friend, a real estate and loan broker (the Broker), inserted unnecessarily into the transaction solely to generate a broker fee that could be shared with the CEO; in fact, the Broker did no actual work to earn a commission on those transactions, but split the “broker’s fee” with the CEO as an illegal kickback.</p>	<p>\$950,000</p>
<p><a href="#">Four Executives Plead Guilty to Fraud Scheme that Caused Over \$4.5 Million in Losses to the Small Business Administration</a></p>	<p>Three former executives of a failed bank and the founder and former President of a lending service provider, plead guilty to scheming to defraud the SBA in connection with its programs to guarantee loans intended for small businesses. The defendants fraudulently obtained loan guarantees from the SBA on behalf of Valley Bank borrowers, knowing that the loans did not meet SBA’s guidelines and requirements for the guarantees. They did so by, among other things, altering loan payment histories, renaming businesses, and hiding the fact that borrowers had previously defaulted on loans. When the fraudulently guaranteed loans defaulted, the defendants caused the submission of reimbursement requests to the SBA to purchase the defaulted loans from investors and lending institutions, thereby shifting the majority of losses on the ineligible loans to the SBA. In all, the defendants attempted to obtain guarantees on over \$14 million in loans, were successful in obtaining guarantees on over \$9 million in loans, and caused the SBA losses of over \$4.5 million.</p>	<p>\$14,000,000</p>
<p><a href="#">Farm Equipment CEO Sentenced to Prison, Order to Pay \$6.3 Million Restitution</a></p>	<p>A Southwest Georgia businessman and owner of a tractor supply company plead guilty to orchestrating a complicated fraud involving millions of dollars of loans by multiple creditors, was sentenced to prison, and ordered to pay restitution to his victims for his crime. In 2016, the defendant falsified documents provided to a bank to secure an SBA loan for \$5 million from the victim Bank. At the same time, the company obtained a new line of credit and signed a credit agreement with the Bank in the amount of \$625,000. During</p>	<p>\$5,625,000</p>

	<p>2015, the company began having financial and cash flow issues which made it difficult to make payments due on the loans and to make payroll. During that time, the defendant began a practice of selling equipment which it held in trust but not paying the cash over to creditors as required. The defendant sold more equipment to secure additional financing from other sources while continuing to use falsified financial information to inflate the company's net worth. As part of falsifying financial records, the defendant initiated a scheme involving reducing accounts payable by generating payment checks but not deducting the amounts from business accounts. The defendant was found to be responsible for restitution for actual monetary losses of \$1.5 million to SBA, about \$1.23 million to the initial victim bank and about \$3.67 million to other victim banks and financial entities.</p>	
<p><a href="#">Former Chief Lending Officer of New Jersey Bank Sentenced to 18 Months in Prison for Making False Statements to United States to Secure Federal Guarantees on Loans</a></p>	<p>A man was sentenced to 18 months in prison for securing a Federal guarantee on certain loans by making false statements to the SBA about the creditworthiness of those loans while serving as the chief lending officer of a New Jersey bank. While serving as the chief lending officer of a New Jersey bank, the defendant became aware of a SBA lending program to incentivize lenders, including banks, to loan money to small businesses by providing a 75 percent SBA-backed guarantee on loans. When a lender applies an SBA guarantee on a loan, the lender must disclose information related to the creditworthiness of the small business. The New Jersey bank hired a consulting firm to help the bank apply for SBA-backed guarantees. On February 29, 2012, a consultant from the consulting firm submitted an application to the SBA for a guarantee of approximately \$3.75 million on loans totaling approximately \$5 million made to a small business located in Robbinsville, New Jersey. The application contained false information related to the creditworthiness of the business. The defendant knew the application contained false information, but he nevertheless reviewed and signed the application on behalf of the bank.</p>	<p>\$5,000,000</p>
<p><a href="#">Jury Convicts in Check Kiting Trial</a></p>	<p>Tyler Gillum (Gillum) was convicted at trial on 31 counts of bank fraud, one count of making a false statement in connection with a SBA guaranteed loan, and one count of making a false statement in a loan or credit card application. According to court documents and evidence presented at trial, Tyler Gillum owned and operated Plainville Livestock Commission Inc. from 2006 until 2019. Between January 2015 and August 2017, Gillum wrote checks and made wire transfers between various accounts under his control at various banks in a scheme commonly known as check kiting<sup>168</sup>. Gillum's scheme resulted in losses of more than \$10 million to the banking system. Gillum also applied for and obtained a \$1,500,000 loan, secured by the SBA, and a \$500,000 line of credit from Almena</p>	<p>\$1,500,000</p>

<sup>168</sup> According to the Department of Justice Press Release, check kiting is when checks are continually written back and forth to fraudulently inflate account balances tricking banks into honoring checks written with insufficient funds.

<p><a href="#">Former President and CEO of Georgia-Based Bank Sentenced to 84 Months in Prison for Role in Bank Fraud Conspiracy</a></p>	<p>State Bank<sup>169</sup>, while concealing he'd previously signed an approximately \$6.1 million promissory note to TBK Bank of Dallas, Texas.</p> <p>A former president and CEO of a Georgia-based bank was sentenced in February 2016 to 84 months in prison for his role in a conspiracy to commit bank fraud and major fraud against the United States. In addition to the prison term, the defendant was ordered to pay \$3,931,018 in restitution to the bank and Federal agencies for losses suffered. The defendant was President and CEO of the now closed bank, Tifton Banking Company (TBC). The defendant hid past-due loans from the FDIC and the TBC loan committee, which resulted in the bank continuing to approve and renew delinquent loans and loans for which the collateral was lacking. Several of the borrowers eventually defaulted on the loans, resulting in millions of dollars in losses to TBC and others. The defendant admitted that in certain transactions in which he exercised approval authority, he made false representations about the loans to TBC's loan committee and hid his personal and business interests. The defendant also admitted to making fraudulent representations that led to commercial loan guarantees being issued by the SBA and U.S. Department of Agriculture on two other loan transactions. The loans were made by the bank and guaranteed by the Government agencies to refinance earlier non-performing commercial loans made by TBC as part of the scheme to mislead bank regulators and hide the bank's true financial condition. Those guaranteed loans resulted in more than \$2 million in losses to the bank and the agencies.</p>	<p>\$2,000,000</p>
<p><a href="#">Two Loan Brokers and One Bank Loan Officer Charged in Bank Fraud Scheme</a></p>	<p>Ted Capodilupo, 56, of South Easton; Joseph Masci, 70, of Boston; and Brian Ferris, 43, of Braintree, were charged with one count each of conspiracy to commit bank fraud. According to the charging documents, between 2015 and 2018, Capodilupo, Masci and Ferris agreed to defraud the bank and the SBA by submitting fraudulent loan applications to the bank, which administered the SBA's small business express loan program, to secure bank loans guaranteed by the SBA. Specifically, it is alleged that Capodilupo and Masci, who operated a loan brokerage business, submitted dozens of fraudulent loan applications to the bank on behalf of borrowers ineligible for traditional business loans. These loan applications misrepresented, among other things, the identity of the real loan recipients and the businesses for which the loans were sought.</p> <p>Capodilupo and Masci also allegedly fabricated federal tax forms submitted in support of the fraudulent loan applications, falsified applicant signatures and falsely indicated that no broker had assisted in preparing or referring the loan applications. Capodilupo and Masci allegedly charged borrowers fees for obtaining these</p>	<p>\$270,000</p>

<sup>169</sup> Almena State Bank failed in October 2020. OIG Report, [Failed Bank Review, Almena State Bank, Almena, Kansas](#) (FDIC OIG FBR-21-003) (March 2021).

fraudulent loans. It is alleged that Ferris, who worked as a loan officer at the bank, caused the bank to issue loans for which Capodilupo and Masci submitted applications and received a kickback from Capodilupo and Masci of approximately \$500 per loan. The alleged scheme generated approximately \$270,000 in fees for Capodilupo and Masci. Many of the loans that the bank issued as a result of the fraudulent applications ultimately defaulted, resulting in substantial losses to the bank.

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This table presents a sample of criminal investigations related to the PPP.

Department of Justice Press Release	Investigation Summary <sup>170</sup>	Estimated Fraud Amount <sup>171</sup>
<a href="#">Defendant Pleads Guilty to Stealing \$24 Million in COVID-19 Relief Money Through Fraud Scheme that Used Synthetic Identities</a>	<p>On June 29, 2021, Hasan Hakim Brown (Brown), pled guilty to one count of conspiracy to commit bank fraud for his role in stealing \$24 million of Covid-19 relief funds by using synthetic identities and shell companies they had created years earlier to commit other bank fraud. Criminals manufacture synthetic identities by using the personal and financial information of real people (such as stolen social security numbers) with fraudulent, made-up information (such as fake names and dates of birth). They use the new, synthetic identities to open fraudulent bank and credit card accounts and commit other fraud.</p> <p>Years before the pandemic, Brown and his co-conspirators used complex computer data storage and virtualization machines to manufacture synthetic identities, automatically open bank accounts and shell companies, and monitor bank activity tied to the synthetic (as well as stolen) identities. In 2017, they used the synthetic and stolen identities and associated bank accounts and shell companies to steal money from a bank in Texas.</p> <p>Then came the COVID-19 pandemic. In March 2020, the CARES Act was enacted. It was designed to provide emergency financial assistance to the millions of Americans suffering the economic effects caused by the COVID-19 pandemic. One source of relief provided by the CARES Act was the PPP, which has authorized hundreds of billions of dollars in forgivable loans to small businesses to use for payroll, rent, utility, and other approved expenses.</p> <p>Brown and his co-conspirators used their already-established synthetic identities and associated shell companies to fraudulently apply for financial assistance under PPP. They applied for and received \$24 million dollars in PPP relief. The money was paid to companies registered to Brown and his co-conspirators, as well as to companies registered to synthetic identities that Brown and his co-conspirators controlled.</p>	\$24,000,000
<a href="#">Liberian National Sentenced to 10 Years for \$23 Million COVID-19 Relief Fraud</a>	<p>A Liberian national who orchestrated a fraudulent scheme to secure more than \$23 million in forgivable PPP loans was sentenced to 10 years in federal prison.</p> <p>Steven Jalloul, a 43-year-old tax consultant from the Dallas area, was first charged via criminal complaint in September 2020; he pleaded guilty in October 2021 to a superseding information charging him with one count of engaging in monetary transactions using property derived from</p>	\$23,000,000

<sup>170</sup> Source: Department of Justice, United States Attorney's Office, Press Releases (Various Districts) and Martinsville Bulletin.

<sup>171</sup> These figures include the amounts related to applications for loans, grants, or unemployment benefits.

<p>unlawful activity. According to plea papers, Mr. Jalloul admitted he defrauded lenders participating in the PPP — a measure authorized by Congress in the early days of the pandemic to award forgivable loans to small business impacted by COVID-19 — while awaiting sentencing in a separate tax fraud case.</p> <p>In court documents, he admitted that he submitted roughly 170 falsified PPP loan applications to lenders (including through a fintech company) seeking more than \$23 million on behalf of over 160 clients of his tax preparation business, Royalty Tax &amp; Financial Services LLC.</p> <p>Mr. Jalloul admitted he inflated clients’ employee rosters and monthly payroll expenses in order to increase the amount of PPP funds for which their businesses would be eligible. He generally charged clients a 2 to 20 percent commission on the PPP loans they received and even listed his ex-wife as Royalty Tax’s authorized representative, without her consent, when seeking an inflated PPP loan for his own business.</p> <p>In total, 97 false PPP loan applications were ultimately approved, and Mr. Jalloul’s clients were awarded more than \$12 million in PPP money. Those clients paid him at least \$972,114 in fees. Mr. Jalloul also admitted to submitting a fraudulent PPP loan application on behalf of his tax preparer company and received \$163,500 in PPP funds.</p>	
<p>On July 28, 2021, a Texas man was sentenced to more than 11 years in prison for wire-fraud and money-laundering offenses in connection with his fraudulent scheme to obtain approximately \$24.8 million in forgivable PPP loans.</p> <p>Dinesh Sah, 55, of Coppell, pleaded guilty on March 24, 2021. According to court documents, Sah submitted 15 fraudulent applications, filed under the names of various purported businesses that he owned or controlled, to eight different lenders seeking approximately \$24.8 million in PPP loans. Sah claimed that these businesses had numerous employees and hundreds of thousands of dollars in payroll expenses when, in fact, no business had employees or paid wages consistent with the amounts claimed in the PPP applications. Sah further submitted fraudulent documentation in support of his applications, including fabricated federal tax filings and bank statements for the purported businesses, and falsely listed other persons as the authorized representatives of certain of these businesses without the authority to use their identifying information on the applications.</p> <p>Based upon his false statements and fabricated documents, Sah received over \$17 million in PPP loan funds and diverted the proceeds for his personal benefit, using them to purchase multiple homes in Texas, pay off the mortgages on other homes in California and buy a fleet of luxury cars, including a Bentley convertible, Corvette Stingray and Porsche Macan. Sah also sent millions of dollars in PPP proceeds in international money transfers. As part of his guilty plea, Sah agreed to forfeit, among</p>	<p>\$24,800,000</p>

[Texas Man Sentenced for \\$24 Million COVID-19 Relief Fraud Scheme](#)

<p><a href="#">California Man Sentenced to Over 11 Years for \$27 Million PPP Fraud Scheme.</a></p>	<p>other property, eight homes, six luxury vehicles and more than \$9 million in fraudulent proceeds that the government has seized to date.</p> <p>In addition to the prison sentence, Sah was ordered to pay \$17,284,649.79 in restitution.</p> <p>A Southern California man was sentenced to 135 months, the equivalent of 11 years and three months, in prison for submitting fraudulent applications seeking money from the PPP, submitting false statements to a financial institution, and money laundering.</p> <p>Robert Benlevi, 53, of Encino, was convicted by a Federal jury of bank fraud, making false statements to a financial institution, and money laundering. According to court documents, and evidence presented at trial, Benlevi submitted 27 PPP loan applications to four banks between April and June 2020 on behalf of eight companies solely owned by Benlevi. In the applications, Benlevi sought a total of \$27 million in forgivable PPP loans. In his fraudulent applications, Benlevi represented that each of his companies had 100 employees and average monthly payroll of \$400,000, even though he knew that the companies did not have any employees or payroll expenses.</p> <p>The evidence further showed that Benlevi also submitted fabricated IRS documents falsely stating that each of the companies had an annual payroll of \$4.8 million. Based on Benlevi’s fraudulent loan applications, three of Benlevi’s companies obtained \$3 million in PPP funds. Although Benlevi falsely represented that the funds sought through the PPP loan applications would be used for payroll and certain other business expenses, the evidence showed that he instead used them for personal expenses, including cash withdrawals, payments on his personal credit cards, transfers to other personal and business accounts he controlled, and renting an oceanfront apartment in Santa Monica.</p>	<p>\$27,000,000</p>
<p><a href="#">Department of Justice Press Release Not Available - See Article for Information</a></p>	<p>Three individuals were indicted for their roles in a scheme to defraud the government of over \$200,000 in COVID-19 relief money and unemployment benefits. Records on file with the U.S. District Court Clerk’s Office in Abingdon claim Pamela R. Ziglar, her husband, Kenneth D. Ziglar, and their daughter, Melody Z. Weese, “developed a scheme” to “file fraudulent claims for funds authorized by various programs under the CARES Act.”</p> <p>According to the indictment, the Ziglars and their daughter “conspired to file fraudulent applications, by means of false and fraudulent representations,” for PPP, unemployment funds, and Economic Injury and Disaster Loan (EIDL) grants. The couple allegedly made material misrepresentations about their business, the number of employees at their business, as well as their employment status as part of these applications. The federal indictment contends they used the PPP and EIDL money to “fund lifestyle expenses including groceries, fuel, general shopping, fast food purchases, and two separate family vacations.” The third individual, their daughter, was employed at the bank where a</p>	<p>\$200,000</p>

<p><a href="#">Two Former Employees at New York Branch Of Major Bank And An Accountant Charged With Cares Act Loan Fraud</a></p>	<p>checking account was opened and used to deposit funds received from these programs.</p> <p>A criminal complaint was unsealed and two criminal informations were filed charging Anuli Okeke, Charlene Wint, and Hashim Campbell, respectively, for their participation in a conspiracy to commit bank and wire fraud in connection with a scheme to fraudulently obtain more than \$3 million from the PPP and EIDL program, both of which were created by Congress as part of the CARES Act. The defendants in this case – two bank officials at a major financial institution and an accountant – are charged with misusing the bank’s operations for their personal benefit, in order to fraudulently obtain Government-guaranteed loans which were intended to help small businesses during the current pandemic.</p> <p>As alleged in the charging documents, Okeke, a branch manager at a large financial institution, Wint, a supervisor at the same branch, and Campbell, a tax preparer, along with their co-conspirators, provided false tax documents and helped borrowers to complete and submit PPP applications that contained fraudulent information. Despite knowing that the PPP applications contained false statements, the branch manager signed each PPP loan application on behalf of the bank and submitted them for approval. Once the loan proceeds were disbursed to the borrowers, defendants and their co-conspirators received kickbacks from the loan proceeds. Moreover, Okeke, Wint, Campbell, and their co-conspirators were involved in preparing fraudulent EIDL applications that fabricated borrower’s financials, and at times sought loans for individuals who were not legitimate business owners.</p>	<p>\$3,000,000</p>
<p><a href="#">Three South Florida Men Sentenced for Conspiring to Launder Fraudulently Obtained Covid-19 Relief Money and Proceeds from Business Email Compromise Schemes</a></p>	<p>A South Florida federal district judge sentenced three Broward County residents to prison terms in December 2021 for conspiring with each other to launder proceeds obtained from business email compromise schemes<sup>172</sup> and fraudulently obtained Covid-19 relief loans.</p> <p>When the coronavirus pandemic hit the United States in 2020, the defendants allegedly initiated a new fraud scheme using existing shell companies from a previous email compromise scheme beginning in 2017, as well as newly created and reactivated shell companies. Defendants allegedly submitted false and fraudulent loan applications under the PPP and EIDL Program. In June and July 2020, through false submissions in the names of their shell companies, the defendants fraudulently applied for and received close to \$2 million in PPP and EIDL funds, which was laundered amongst the co-conspirators.</p>	<p>\$2,000,000</p>

<sup>172</sup> According to the U.S. Department of Justice Press Release, a business email compromise scheme is a type of computer intrusion that occurs when an employee of a company is fooled into interacting with an email message that appears to be, but is not, legitimate. When an unwitting user clicks on either the link or the attachment, it releases some form of malware (i.e., a virus, spyware, or other program application) that subsequently infects the employee’s email and/or computer. The malware may affect

<p><a href="#">South Florida U.S. Attorney's Office to Lead COVID-19 Fraud Strike Force Team Against Pandemic Relief Fraud</a></p>	<p>The Southern District of Florida charged Daniel Hernandez, 50, a Market Manager for a top national bank, with orchestrating a \$30 million COVID-19 relief fraud scheme. According to the criminal complaint affidavit, Hernandez – who oversaw 80 bank employees and more than 20 branches throughout South Florida – recruited bank customers and at least one former bank employee to submit over 90 fraudulent PPP loan applications. It is alleged that Hernandez advised the recruits on how to file the applications and what to include in them, then used his position at the bank to ensure the fraudulent loans were reviewed and, when possible, approved. The applications sought over \$30 million in fraud proceeds. The investigation to date has identified over \$15 million in fraudulent loans issued.</p> <p>In addition to Hernandez, the Southern District has charged others with participating in the fraud. Willian Alexander Posada Sandrea pled guilty and is scheduled to be sentenced on October 24, 2022.</p> <p>Armando De Leon, who worked at the bank with Hernandez, was charged with conspiracy to commit wire fraud. Javier Alfonso Barata, and Alvaro Enrique Castillo along with Douglas David Melean Socorro have also been charged.</p>	<p>\$30,000,000</p>
<p><a href="#">Federal Complaint Filed Against Austin Man for Multi-Million Dollar Fraud Scheme Related to the SBA Paycheck Protection Program During COVID-19 Pandemic</a></p>	<p>Michael McQuarn was arrested for allegedly defrauding the SBA PPP of more than \$2 million. A criminal complaint charges McQuarn with wire fraud and making false statements to the SBA. The complaint alleges that he implemented a scheme whereby he submitted fraudulent applications and supporting paperwork of two fictitious companies he created to secure SBA-backed PPP loans. McQuarn claimed the funds were for legitimate business purposes when, in fact, the money was used for his own personal use, including purchasing a 26' Pavati Wake Boat and a Rolls Royce.</p>	<p>\$2,000,000</p>

an employee's individual account or spread throughout the computer network. The malware, once executed, can harvest information including but not limited to credentials and passwords, thereby giving the intruder access to sensitive company information.

This table presents the bank names associated to the unique bank identifiers used throughout this report.

Bank Reference Used in Report	Bank Name	FDIC Certificate Number	Region
Bank 1	(b) (8)		
Bank 2	(b) (8)		
Bank 3	(b) (8)		
Bank 4	(b) (8)		
Bank 5	(b) (8)		
Bank 6	(b) (8)		
Bank 7	(b) (8)		
Bank 8	(b) (8)		
Bank 9	(b) (8)		
Bank 10	(b) (8)		

Source: FDIC OIG created unique identifiers based on information identified in FDIC supervisory workpapers



**Federal Deposit Insurance Corporation**  
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Division of Risk Management Supervision

**TO:** Terry L. Gibson  
Assistant Inspector General, Audits, Evaluations, and Cyber  
Office of Inspector General

**FROM:** Doreen R. Eberley <sup>DOREEN</sup> <sup>EBERLEY</sup> (b) (6)  
Director, Division of Risk Management Supervision

**DATE:** April 21, 2023

**RE:** Draft Evaluation Report Entitled, *FDIC Examinations of Government-Guaranteed Loans (No. 2021-006)*

#### BACKGROUND

The FDIC has completed its review of the Office of Inspector General's (OIG) draft evaluation report titled "FDIC Examinations of Government-Guaranteed Loans (GGLs) (No. 2021-006)" provided on April 11, 2023 ("draft report"). FDIC management concurs with thirteen of the nineteen recommended actions in the draft report and partially concurs with six recommendations. Responses to the recommendations are provided at the end of this document.

The FDIC appreciates the opportunity to comment on draft findings and recognizes that some changes were made to previous drafts. However, the FDIC continues to disagree with certain findings within this draft report and shares select illustrations of its disagreements below.

#### CONTEXT REGARDING GGL

The FDIC agrees that, as with any type of lending activity, GGL activities can present risks (e.g., operational, credit, liquidity) to FDIC-insured and FDIC-supervised institutions if conducted without proper due diligence and risk management. The OIG cites three failures in the draft report for which GGL activities contributed to failure. In reviewing records for the three failures cited by OIG, although GGL activity was present and problematic, it was not in and of itself the proximate cause of failure.

With respect to (b) (8) comments and analysis, the FDIC agrees that there are many FDIC-insured institutions that participate in (b) (8) and acknowledges the statistic in the draft report that FDIC-supervised institutions' disbursements (b) (8). Nevertheless, these originations remain a small portion of FDIC-supervised institutions' commercial and industrial loans outstanding, as shown below, and it is also likely that balances may be skewed by impacts of the pandemic.

Year	(b) (8) Govt	YoY Growth	# of FDIC Banks	Total C&I		
	Gty Loans Originated			Balances less (b) (8)	YoY Growth	# of FDIC Banks
2017	\$ 12,147,992		847	\$ 281,765,852		3,554
2018	\$ 11,437,939	-5.8%	827	\$ 304,944,772	8.2%	3,408
2019	\$ 10,919,822	-4.5%	794	\$ 361,635,141	18.6%	3,256
2020	\$ 12,012,222	10.0%	834	\$ 346,305,730	-4.2%	3,152
2021	\$ 19,584,640	63.0%	916	\$ 413,394,210	19.4%	3,050

Source: FDIC and OIG Report. Note: All figures include FDIC-supervised banks only. (b) (8) are origination volumes and C&I are balances outstanding.

#### CONTEXT REGARDING THE PAYCHECK PROTECTION PROGRAM (PPP)

The PPP was one of several programs designed to provide credit to small businesses struggling with the unprecedented impacts of the global pandemic. Attached as Appendix A is a timeline of notable public documents that describe the establishment and rollout of the PPP as well as Federal banking agency, interagency and FDIC rulemakings and awareness efforts. Among other actions, the timeline describes interagency rulemakings to neutralize the effects of bank participation in the PPP and related liquidity facilities on pertinent capital and liquidity regulations, and the FDIC's rulemaking to mitigate effects on deposit insurance pricing.

On June 22, 2020, the FDIC issued an internal Regional Director Memorandum (RD Memorandum) to examination staff entitled Examination Considerations Related to the Paycheck Protection Program. The June 2020 RD Memorandum described the PPP, the SBA rulemakings governing administration of the program, interagency banking rulemakings related to the program, examination considerations, credit considerations, liquidity considerations, and capital considerations.

The dollar volume of PPP loans extended by all FDIC-insured institutions peaked in the first quarter 2021 at \$471 billion, and the number of loans extended by all FDIC-insured institutions peaked in that same quarter at 5.02 million. For FDIC-supervised institutions, the peak loan volume occurred in the third quarter 2020 at \$185 billion, and the number of loans peaked in the first quarter 2021 at 1.99 million. As of December 31, 2022, the dollar volume of loans extended by all FDIC-insured institutions has declined by 98 percent to \$10.2 billion, and the number of outstanding loans has declined by 95 percent to 232,000. For FDIC-supervised institutions, the dollar volume of PPP loans outstanding has declined by 98 percent to \$4.3 billion, and the number of PPP loans outstanding has declined by 94 percent to 121,000.

Beginning with data from first quarter 2022, in addition to regular supervisory activities, RMS staff began quarterly monitoring of insured institutions with remaining PPP concentrations in excess of 100 percent of tier one capital plus loan loss reserves, dropping this threshold to 50 percent as of

the third quarter 2022, as balances continued to decline. As of December 31, 2022, only two FDIC-insured institutions have PPP balances outstanding in excess of 50 percent of tier one capital plus loan loss reserves, one supervised by the FDIC and one by another Federal regulator.

#### EXAMINER GUIDANCE AND INSTRUCTIONS

The FDIC currently has limited guidance for examiners specific to GGL activities. However, the FDIC has broadly applicable guidance and examination instructions for reviewing lending activities of any type, including GGLs. The FDIC and the other banking agencies have been examining insured institutions that engage in GGL for decades as part of the regular examination process, at least since the inception of (b) (8) the other Federal guaranty agencies without examiner guidance specific to GGL activities.<sup>1</sup> During this time, FDIC examiners have used the Division of Risk Management Supervision (RMS) Manual of Examination Policies (RMS Manual)<sup>2</sup> and other examination resources to identify the material risks in GGL lending activities, including those related to credit quality (loan classification), off-balance sheet risk, and concentration risk.<sup>3</sup>

The FDIC disagrees with the OIG's conclusion that existing FDIC guidance did not provide sufficiently detailed information to allow examiners and Case Managers to consistently address bank activities in GGLs for loan classification, off-balance sheet risk, concentration risk and ongoing monitoring. As discussed more fully below, the FDIC disagrees that the examples provided by the OIG to illustrate inconsistent application of guidance support that conclusion.

The FDIC also disagrees with the OIG's conclusions regarding FDIC guidance as compared to that of the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System (FRB). In particular, with respect to concentration<sup>4</sup> guidance, although instructions between the agencies for identifying and reporting concentrations within the Report of Examination (ROE) differ, the OIG has not supported its assertion that FDIC examination instructions may result in fewer concentration determinations for FDIC-supervised financial institutions than for institutions supervised by other Federal regulators.

The FRB and the OCC have concentration *identification* thresholds for product lines at 25 percent of tier one capital and applicable reserves,<sup>5</sup> but the listing of a product line at 25 percent

<sup>1</sup> The FDIC acknowledges that the OCC issued guidance titled SBA Lending: Risk Management Principles (OCC SBA Guidance) during the pendency of this audit in August 2021. The guidance addresses SBA lending, not GGL in general. See <https://www.occ.gov/news-issuances/bulletins/2021/bulletin-2021-34a.pdf>.

<sup>2</sup> FDIC: <https://www.fdic.gov/regulations/safety/manual/index.html>

<sup>3</sup> FDIC – RMS Manual: Section 1.1 Basic Examination Concepts; Section 2.1 Capital; 3.1 Asset Quality, Section 3.2 Loans; Section 3.7 Other Assets and Liabilities, Section 3.8 Off-Balance Sheet Activities; section 5.1 Earnings, Section 6.1 Liquidity and Funds Management, and Section 16.1 Report of Examination Instructions.

<sup>4</sup> FDIC defines concentrations as “pools of assets that share common risk characteristics or have heightened sensitivity to similar economic, financial, or other risk factors.” FRB and OCC have similar definitions.

<sup>5</sup> Refer to:

▪ OCC: <https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/concentrations-of-credit/index-concentrations-of-credit.html> 2

in a ROE is not required. The FRB states that the Concentration page itself is not required to be included in the ROE unless there are materially deficient practices in managing concentrations. The OCC guidance requires examiners to note concentrations that pose a challenge to management or that present unusual or significant risk to the bank in the ROE. In contrast, the FDIC has instructions that *require* examiners to list concentrations at 100 percent and to provide written analytical comments for concentrations at 300 percent. Further, FDIC examiners are given the flexibility to schedule concentrations at lower amounts when risk elements are present.<sup>6</sup> The OIG appears to have based its comments on the publicly available guidance from the FRB and OCC, but does not appear to have tested application of that guidance in FRB and OCC ROEs.

It has been the FDIC's experience that most concentration listings in ROEs, regardless of Federal bank regulator, focus on the unguaranteed portion<sup>7</sup> as presenting higher credit risk, and that write-ups and presentation styles, when included, vary appropriately. In addition, contrary to the OIG's suggestion, the FDIC does not typically see portions of GGL loans *sold* included in concentration listings, as the sold portions of GGL loans are not assets or funding liabilities of an institution. The FDIC has seen such risks discussed in the context of off-balance sheet risk, including in Bank 2 cited by the OIG in this draft report, when it is appropriate to do so, consistent with instructions in the RMS Manual. The (b) (8) Guidance appears to suggest similar treatment as it states, in part (b) (8)

The Federal banking agencies have also issued joint guidance regarding concentration calculations in an effort to "maintain a consistent approach for all banking organizations."

The draft report does not address interagency guidance used by all agencies to assess asset quality, notably the *Uniform Financial Institutions Rating System (UFIRS)*<sup>10</sup> and the uniform asset classification definitions set forth in the *Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions (See Attachment 1 - Interagency Loan Classification Definitions)*.<sup>11</sup> Although application of the interagency rating system and interagency classification definitions requires the staffs of the Federal banking agencies to make judgments based on the specific facts and circumstances of each institution and each loan reviewed, the common definitions ensure consistency in assessing asset quality and assigning loan classifications amongst the agencies, irrespective of an agency's topic-specific guidance. Findings in the draft report that suggest FDIC's assessments of loan classifications are different than that of the OCC appear to be based on the absence of GGL-specific loan classification guidance as opposed to documented evidence that the FDIC judgements actually differed from

FRB: <https://www.federalreserve.gov/publications/files/cbem.pdf> (Section 2050, Concentrations of Credit)

<sup>6</sup> Refer to RMS Manual Section 16.1- Report of Examination Instructions Concentrations

<https://www.fdic.gov/regulations/safety/manual/section16-1.pdf>

(b) (8)

<sup>9</sup> <https://www.fdic.gov/news/financial-institution-letters/2020/fil20031a.pdf>

<sup>10</sup> <https://www.govinfo.gov/content/pkg/FR-1996-12-19/pdf/96-32174.pdf>

<sup>11</sup> <https://www.fdic.gov/news/financial-institution-letters/2013/fil13051a.pdf>

the OCC's when faced with the same fact patterns.

As a general matter, in various areas of the draft report, the OIG acknowledges the FDIC's risk-focused approach to supervision,<sup>12</sup> but then contradicts this philosophy through criticisms that favor a formulaic or otherwise one-size-fits all approach. For example (and as more fully described below), the OIG criticizes the FDIC for conducting loan level transaction testing for adherence to GGL program requirements for one institution versus another, apparently based on the size of (b) (8) portfolios without regard to other governance and risk management factors related to those institutions. As another illustration, the OIG criticizes the FDIC for not specifying the level of PPP loan volume that triggers a heightened review in the previously mentioned June 2020 RD Memorandum issued to examiners, again without acknowledgement of other governance and risk management factors considered by examiners as part of examination planning activities. As described more fully above, as PPP balances have declined substantially, the FDIC has implemented a process of heightened monitoring for the few institutions with notable remaining balances.

#### CONDUCT OF EXAMINATIONS

The FDIC disagrees with the OIG's interpretations and proposed applications of U.S. Generally Accepted Accounting Principles (GAAP) outlined in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 450-20, Loss Contingencies. In two examinations cited by the OIG in its draft report, the OIG suggests that examiners have more latitude than FDIC believes is prescribed by accounting guidance. Notably, in Bank 2 and Almena State Bank, the OIG indicates that examiners should have recognized a liability account, or recommended that the bank disclose in its audited financial statements, a possible loss for the guaranteed portions of GGLs sold on the secondary market. The OIG bases its findings on examiners' classification of the associated retained unguaranteed portions of GGLs and descriptions of generally hazardous lending practices as opposed to a determination that the facts and circumstances of the individual loans met the criteria of ASC Subtopic 450-20.

The FDIC does not agree that a loss contingency should have been accrued, given the information available to the examiners at the time of the examination, as this would not have been consistent with GAAP. As described in FASB ASC paragraphs 450-20-25-1 and 450-20-25-2, GAAP requires recognition of a liability through the accrual of a loss contingency when information available prior to the issuance of the financial statements indicates it is *probable* that an asset has been impaired at the date of the financial statements and the amount of loss can be

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<sup>12</sup> Risk-focused supervision was adopted by the FDIC, the FRB, and the Conference of State Bank Supervisors in 1997 as a framework for carrying out examination activities. Risk-focused supervision uses a tiered approach in which the scope of examinations and resources are focused on the areas in an institution presenting the greatest risks. See RMS Manual, Section 1.1 Basic Examination Concepts and Guidelines, Risk-Focused Supervision: <https://www.fdic.gov/regulations/safety/manual/section1-1.pdf> and RMS Manual Section 20.1 Risk-Focused, Forward-Looking Safety and Soundness Supervision: <https://www.fdic.gov/regulations/safety/manual/section20-1.pdf>

*reasonably estimated.* If these conditions are met, accrual should be made. The presence of generally hazardous lending practices does not alone indicate that it is probable that a loss will be incurred on a (b) (8) loan or that the amount can be reasonably estimated. The accounting standard, ASC Topic 450, distinguishes *probable* from *reasonably possible*, when determining whether a contingent liability should be accrued.

As to the OIG's suggestion that examiners should have required the bank to disclose in its audited financial statements a possible loss related to the sold loans, the FDIC does not have authority to instruct an institution what to disclose in audited financial statements. FDIC examiners' responsibility is to verify whether the insured institution accurately calculates and reports data in the Consolidated Reports of Condition and Income (Call Report). While banks are subject to certain audit and reporting requirements, depending on bank size, these requirements do not encompass financial statement disclosures.<sup>13</sup> Both of the financial institutions cited by the OIG did have audited financial statements, although not required, and those independent auditors came to the conclusion to not require disclosure or to accrue a loss contingency.

The OIG suggests the FDIC establish guidance to define conditions that meet the thresholds of being "probable" and "reasonably estimable," even though the FDIC provided the OIG with ample GAAP guidance that is already available within the Implementation Guidance and Illustrations section of the accounting standards, which is also referenced in the Call Report glossary entry for "Loss Contingencies."<sup>14</sup> FDIC's senior accounting staff communicated to the OIG via email on February 3, 2023, that the terms associated with loss contingencies, such as "probable," "reasonably possible," and "remote" are all defined in the ASC Master Glossary.<sup>15</sup> Senior staff also shared, as they had previously on January 12, 2023, the section "Contingencies—Loss Contingencies—Implementation Guidance and Illustrations,"<sup>16</sup> which provides guidance for assessing the probability of the incurrence of loss and whether a loss is reasonably estimable. Further, establishing guidance to require FDIC examiners to accrue a contingent liability when a future event is possible rather than probable would deviate from GAAP, treat FDIC-supervised institutions differently from institutions supervised by the FRB or OCC, and could ultimately have a chilling effect on FDIC-supervised institutions' participation in GGL activities.

As a general matter, the FDIC believes that its supervision of the example institutions described in the draft report was appropriate. All of the examinations discussed in the draft report addressed GGL activities, and were conducted in accordance with the FDIC's risk-focused, forward-looking supervision approach that addresses an institution's business model, risk profile, complexity, and size. In the five banks tested by the OIG for supervision of GGL, the FDIC identified and addressed risks related to GGL programs, including through Matters Requiring

<sup>13</sup> Section 36 of the Federal Deposit Insurance Act (FDI Act) and Part 363 of the FDIC's regulations impose annual audit and reporting requirements on insured depository institutions with \$500 million or more in consolidated total assets. Once a bank reaches \$1 billion in assets, additional requirements apply.

<sup>14</sup> <https://www.fdic.gov/resources/bankers/call-reports/crinst-031-041/2022/2022-12-gloss.pdf>

<sup>15</sup> <https://asc.fasb.org/MasterGlossary>

<sup>16</sup> FASB ASC paragraphs 450-20-55-12 through 450-20-55-17, <https://asc.fasb.org/1943274/2147483051>

Board Attention (MRBA), Supervisory Recommendations, informal and formal enforcement actions, and CAMELS ratings. FDIC staff provided comments to the OIG regarding its disagreement with conclusions in the draft report related to the examination treatment of GGLs at sampled banks, and will provide only a few examples in this response for illustrative purposes.

***FDIC examiners assessed GGLs against associated program requirements consistent with risk-focused supervision principles***

The OIG criticizes the FDIC for inconsistent examination approaches for evaluating GGLs against associated program requirements in three institutions, despite the significant variance in terms of business model, risk profile and complexity of these institutions. The FDIC disagrees with the OIG's suggestion that the scope of these reviews were inconsistent and instead, believes they were aligned with the banks' business model, risk profile and complexity.

In the case of Bank 2, the OIG criticizes examiners for not testing for compliance with agency program requirements in 2015 and 2016, after the bank implemented a strategy to originate GGLs at the end of 2013. The OIG does not acknowledge or include in the draft report that examiners performed a credit quality and risk management assessment of the GGL program in 2014, when the bank had underwritten only twelve loans under the program, and included fifteen supervisory recommendations to strengthen policy guidance, underwriting and ongoing portfolio monitoring. In 2015, examiners sampled and reviewed the underwriting of GGLs and included supervisory recommendations for bank management to obtain accurate borrower financial statements; ensure comprehensive credit risk analysis; expand underwriting guidelines for start-up businesses; and track, monitor and report on default rates and score band performance. Similarly, in 2016, examiners sampled GGLs and identified weaknesses with underwriting and portfolio monitoring practices. In several instances, examiners highlighted the importance of meeting the Federal guaranty agency's program requirements and also included commentary about the need to ensure proper resources and staffing to oversee the growing GGL portfolio. The draft report omits that the FDIC's examination findings led to rating downgrades and the issuance of a Consent Order several months ahead of the Federal guaranty agency's enforcement actions.

The OIG also criticizes examiners for not evaluating GGL loans against program requirements in Bank 3, where GGLs represented 38 percent of total assets, and instead relying on reviews conducted by the Federal guaranty agency and independent audit reports. The OIG noted that, in its view, this was in contrast to examiners evaluating GGL loans against program requirements at Bank 4 when GGLs represented only 3 percent of total assets. The OIG does account for the other risk factors considered by examiners, such as Bank 3's long history of strong risk management over GGL activities that had been reviewed over successive examinations versus Bank 4's recent changes in management and plans for GGL expansion. The OIG also does not acknowledge that notwithstanding Bank 3's low risk factors, examiners' review of GGL activities was comprehensive, and included review of policies and procedures, compliance with applicable laws and regulations, internal routine and controls, and accuracy of risk ratings.

Furthermore, the OIG criticizes examiners for relying upon third party audits, when a key tenet of risk-focused supervision in determining the scope of transaction testing, is that examiners "should

consider the adequacy of audit and control practices in determining a bank's risk profile and, when appropriate, try to reduce regulatory burdens by testing rather than duplicating the work of a bank's audit and control functions."<sup>17</sup> In the case of Bank 3, aside from receiving the strongest audit assessments from the GGL agency, the Bank had received three external audits and one internal audit of the GGL loan portfolio, all of which had satisfactory findings.

***FDIC examiners treated the guaranteed portion of GGLs appropriately when assigning classifications***

The OIG criticizes examiners for excluding the *guaranteed* (on-balance sheet) portion of certain GGLs from adverse classification at two institutions when they had adversely classified the unguaranteed portion (on-balance sheet) substandard, and suggests that this exclusion caused an understatement of the Allowance of Loan and Lease losses (ALLL). In the case of Bank 5, the OIG cites one loan because Bank management discussed a potential loan workout strategy it was contemplating that, if enacted, *may* have caused the loan to become ineligible for guaranty. In the case of Almena State Bank, the OIG suggests examiners should have classified the guaranteed portion of *all* GGLs for which examiners had classified the unguaranteed portion substandard, solely because of hazardous lending practices in general, which generally related to the bank's issuance of additional unsecured credits to borrowers with GGLs, and regardless of the facts and circumstances of each loan. It is noted that in its Failed Bank Review Memorandum (FBR-21-003) of Almena State Bank dated March 26, 2021, during the pendency of this audit, the OIG "found that the FDIC's "supervision identified and effectively addressed the issues that led to the bank's failure and the loss to the DIF."<sup>18</sup>

In order to classify a loan Substandard under the interagency classification definitions, the loan must have "a well-defined weakness or weaknesses that jeopardize the liquidation of the debt." For the reasons previously noted, the presence of hazardous lending practices generally does not alone support adverse classification of a specific loan or loans guaranteed by a Federal guaranty agency. For example, in the case of Almena, at the time of the examination, there had been no GGL claim denials, and the issuing agency stated in its assessment of the portfolio that "guaranty impairment risk was low." Further, adverse classification of a loan does not mean that the bank did not follow agency rules; GGL borrowers are by their nature higher risk and receive the guaranty as a credit enhancement to encourage institutions to lend. Finally, institutions must analyze the collectability of their loans and leases held for investment and maintain an ALLL at a level that is appropriate and determined in accordance with GAAP. An appropriate ALLL covers estimated credit losses, involves a high degree of judgment, and results in a range of estimated losses. Accordingly, there is not always an automatic additional ALLL allocation when loans are subsequently classified.

<sup>17</sup> RMS Manual, Section 1.1 Basic Examination Concepts, Risk-Focused Supervision  
<https://www.fdic.gov/regulations/safety/manual/section1-1.pdf>

***FDIC examiners appropriately presented GGL concentrations and assessed GGLs for concentration risk***

The OIG criticizes examiners for not including the guaranteed portion of loans *sold* in the ROE concentration listings of GGLs in three institutions, and, as a result, asserts that potential harm from this exposure was not assessed. The OIG does not acknowledge or report that the RMS Manual ROE preparation instructions direct examiners to list asset or funding concentrations on the concentrations pages, and to discuss any concerns with recourse risk with sold loans under the CAMELS ratings most impacted.<sup>19</sup> As mentioned previously, this treatment appears consistent with that of the other Federal bank regulators. The FDIC disagrees with the OIG's criticisms.

More importantly, the OIG does not acknowledge or include in the draft report that concentration and off-balance sheet risk, as applicable, was assessed in all three institutions consistent with the bank's business model and risk profile. In the Case of Bank 2, concerns with the bank's GGL concentration and concentration risk management practices had been identified in the 2017 and 2018 ROEs. These, and other concerns with Bank 2's concentrated lending strategy resulted in increasingly more stringent corrective actions, including a Consent Order that, among other provisions, imposed growth restrictions and a maximum concentration limit. As a result, the 2020 ROE, which is the source of OIG criticism, not only had extensive analysis of the GGL concentration itself, but also extensive discussion of concentration risk throughout the report, including on the ROE page titled Compliance with Enforcement Actions. Concerns with potential exposure from off-balance sheet (denial) risk associated with sold GGL loans also permeated the 2020 ROE of Bank 2, including in the very first MRBA, in the Examiner Comments and Conclusions pages, and in the CAMELS ratings.

In the Case of Bank 5 and Bank 3, examiners appropriately excluded off-balance sheet sold loans from the concentration calculations, and more importantly, appropriately assessed GGL concentration risk. As part of the concentration analysis for Bank 5, examiners noted that loans had to be underwritten to the Federal guaranty agency's guidelines and approved by the Federal guaranty agency prior to funding and the issuance of a guaranty. Examiners did not identify any concerns with exposure to off-balance sheet risk related to GGL, and neither of the banks had received any agency denials. Accordingly, examiners had no concerns to discuss under the CAMELS ratings.

Finally, examiners appropriately presented the GGL concentrations in the three institutions cited, consistent with their business model, risk profile and complexity. In Bank 3, examiners did not cite a GGL concentration in the ROE because it was below the 100 percent threshold and there

<sup>19</sup> RMS Manual Section 16.1- Report of Examination Instructions, for the Comparative Statements of Financial Condition schedule, under *Derivatives and Off-Balance Sheet Items*, states in part "Include only Category I contingent liabilities (contingencies that give rise to accompanying increases in assets if the contingencies convert into actual liabilities). Do not include Category II contingent liabilities (those that are not expected to result in an increase in assets if converted to actual liabilities). Significant Category II contingent liabilities should be discussed on the ECC page under the financial aspect most significantly affected (for example, capital, management, earnings, or liquidity)."

were no other risk elements present given the institution's long history of strong oversight of GGL activities. In Bank 5, examiners presented both the guaranteed and unguaranteed portions of the GGLs in the ROE because these amounts were retained by the bank and the presentation helped to differentiate risk within the concentration. This contrasts with Bank 2, where examiners presented the unguaranteed portion of GGLs in the ROE, but excluded the guaranteed portion, because the bank sold the guaranteed portion of the GGLs and they were no longer on the balance sheet. These presentations in the ROE are consistent with ROE instructions.

#### **FDIC Management Response to Recommendations**

RMS concurs with thirteen recommendations and partially concurs with six recommendations.

**Recommendation 1:** We recommend that the FDIC Director of RMS develop and implement guidance to examination staff on the credit, operational (including fraud), liquidity, and compliance risks related to Government- guaranteed loans to ensure staff adequately plans and conducts examinations to identify and address emerging risks.

***Planned Action (1):*** Concur. RMS staff will update the RMS Manual to ensure that examination guidance on GGL risks and activities, including the assessment of loan classifications, concentrations, and off-balance sheet risk is comprehensive and centralized for better access. RMS staff will communicate the changes to examiners through an RD Memorandum.

***Estimated Completion Date (1):*** January 31, 2024.

**Recommendation 2:** We recommend that the FDIC Director of RMS develop and implement guidance to examination staff to ensure the staff consistently evaluate GGLs in their review of loan classification, assessment of off-balance sheet risk, concentration risk, and ongoing monitoring.

***Planned Action (2):*** Concur. RMS staff will update the RMS Manual to ensure that examination guidance on GGL risks and activities, including the assessment of loan classifications, concentrations, and off-balance sheet risk is comprehensive and centralized for better access. RMS staff will communicate the changes to examiners through an RD Memorandum.

***Estimated Completion Date (2):*** January 31, 2024.

**Recommendation 3:** We recommend that the Director, RMS update and implement the Examination Profile Script to include additional questions on financial institution participation in Government-guaranteed loan programs in order to identify and address emerging risk.

***Planned Action (3):*** Concur. RMS staff will update the Examination Profile Script List to include additional questions to identify bank participation in GGLs. RMS staff will communicate the changes to examiners through an RD Memorandum.

**Estimated Completion Date (3):** September 30, 2023.

**Recommendation 4:** We recommend that the Director, RMS develop and implement additional items to the Safety and Soundness Request List to identify Government-guaranteed loans, the performance of those loans, and status of the guaranty.

**Planned Action (4):** Partially concur. Examiners-in-charge will be instructed to include on Safety and Soundness Request Lists, a request that bank management identify GGLs and provide relevant risk and risk management related information, as appropriate, and when consistent with the FDIC's risk-focused, forward-looking approach to examinations. RMS staff will communicate the changes to examiners through an RD Memorandum.

**Estimated Completion Date (4):** September 30, 2023.

**Recommendation 5:** We recommend that the Director, RMS issue and implement guidance to require that examination staff conduct a fraud risk assessment on future Government-guaranteed loan programs involving FDIC-insured and FDIC-supervised financial institutions to inform policy decisions.

**Planned Action (5):** Concur. The RMS Director will issue an RD Memorandum with an operating procedure that requires Washington Office policy staff to develop a risk assessment on future Government-guaranteed loan programs involving FDIC-insured and FDIC-supervised institutions that will include an assessment of applicable risks, including fraud risk, related to safety and soundness for those institutions participating in the program.

**Estimated Completion Date (5):** January 31, 2024.

**Recommendation 6:** We recommend that the Director, RMS ensure guidance on future Government-guaranteed loan programs includes all risks associated with such programs and has instructions to allow for consistency in supervisory activities.

**Planned Action (6):** Concur. The RD Memorandum operating procedure described in response to recommendation 5 will require that future guidance include all risks associated with future Government-guaranteed loan programs and have instructions to allow for consistency in supervisory activities.

**Estimated Completion Date (6):** January 31, 2024.

**Recommendation 7:** We recommend that the Director, RMS issue and implement guidance for examiners clarifying the FDIC supervisory expectations for reviewing bank PPP activities, including the level of PPP loan volume triggering a heightened review, how examiners should assess the PPP activities of banks that have existing BSA/AML weaknesses, and protocols for examination staff to communicate observed weaknesses

**Planned Action (7):** Concur. RMS staff will update the June 2020 RD Memorandum to describe

existing procedures for heightened monitoring for banks with remaining exposure in excess of 50 percent of tier one capital plus appropriate loan loss reserve. The memorandum will refer to existing communications protocols, including reports of examination, transmittal letters, target review letters, and discussions with primary Federal regulators and state regulators to communicate observed weaknesses. Revisions will also emphasize the importance of expanding reviews when existing AML/CFT controls display weaknesses.

***Estimated Completion Date (7):*** May 31, 2023.

**Recommendation 8:** We recommend that the Director, RMS revise and implement FDIC guidance and practices for assessing concentrations and loan classification to ensure uniform application with the other Federal bank regulators of supervisory approaches to banks.

***Planned Action (8):*** Partially concur. RMS agrees to take the action described in Recommendation 9 to coordinate with the other Federal bank regulators. Based on that coordination, RMS agrees to determine whether revisions are needed to FDIC guidance and practices for assessing concentrations and loan classification to ensure uniform application of supervisory approaches with the other Federal regulators.

***Estimated Completion Date (8):*** January 31, 2024.

**Recommendation 9:** We recommend that the Director, RMS coordinate with the other Federal bank regulators to ensure uniform application of supervisory approaches to banks regarding concentrations and loan classification.

***Planned Action (9):*** Concur. RMS staff will discuss supervisory approaches to banks regarding concentrations and loan classification with the other Federal bank regulators. The discussion will be documented in a memorandum to the RMS Director from policy staff.

***Estimated Completion Date (9):*** January 31, 2024.

**Recommendation 10:** We recommend that the Director, RMS develop and implement a training plan to ensure examination staff are trained on the requirements and risks of Government-guaranteed loan programs.

***Planned Action (10):*** Concur. RMS will develop and provide training consistent with the planned updates the RMS Manual, Examination Profile Script, and Examiner Request List described in the responses to recommendations 1, 2, 3 and 4.

***Estimated Completion Date (10):*** March 31, 2024.

**Recommendation 11:** We recommend that the Director, RMS update, develop, and distribute to FDIC examination personnel a list of FDIC examiners who have significant experience examining banks that specialize in Government-guaranteed loan programs to regional offices.

**Planned Action (11):** Concur. RMS staff will develop and distribute a list of employees that have specialized experience in GGL programs via a RD Memorandum.

**Estimated Completion Date (11):** September 30, 2023.

**Recommendation 12:** We recommend that the Director, RMS develop and implement a process to obtain improved data regarding Government-guaranteed lending activities of FDIC-supervised financial institutions.

**Planned Action (12):** Partially concur. RMS staff agree to take action consistent with the spirit of the recommendation; however, RMS staff do not fully control the ability to take action. As described on page 42 of the draft report, “The primary tool for the FDIC to collect bank data is the Call Report. However, government-guaranteed loans are not an item listed in this report.” The Call Report and the instructions for completing the Call Report apply to all FDIC-insured institutions, not just FDIC-supervised institutions, and are under the purview of the Federal Financial Institutions Examination Council (FFIEC), which includes the FDIC, the OCC, the FRB, the National Credit Union Administration (NCUA), the Consumer Financial Protection Bureau (CFPB), and the State Liaison Committee (SLC).<sup>20</sup> Updates to the Call Reports are also issued for comment under the Paperwork Reduction Act. Members can bring recommendations and requests to the FFIEC and collectively determine the most appropriate way to obtain the data requested, if an agreement can be met. Under the auspices of the FFIEC, the member agencies prescribe uniform principles, standards, and report forms; promote uniformity in the supervision of financial institutions; and minimize reporting burden.

RMS will, however, provide a link on its internal webpage to (b) (8) which contains portfolio information for its various Government-guaranteed loan programs. This resource was referenced by the OIG in the draft report as follows (b) (8)

In addition, RMS staff will work with the Division of Insurance and Research to determine whether any other reports from (b) (8) other Federal guaranty agencies may be helpful to examiners.

**Estimated Completion Date (12):** Add link by June 30, 2023.

**Recommendation 13:** We recommend that the Director, RMS update the (b) (8) to include the sharing of loan portfolio information such as historical loan performance, status of guaranty, and loan level risk characteristics.

**Planned Action (13):** Partially concur. RMS staff agree to take action consistent with the spirit of the recommendation; however, RMS staff do not fully control the ability to take action. By operation, an MOU is a multiparty, in this case two-party, agreement, and the FDIC cannot unilaterally update it. The FDIC entered into the MOU (b) (8) described the information it wanted from the FDIC: specifically, advanced notice of the

<sup>20</sup> <https://www.ffiec.gov/>

issuance of formal enforcement actions on covered institutions (b) (8)

RMS staff agree to initiate discussions with (b) (8) to whether loan portfolio information as described in the recommendation is available for (b) (8) and whether (b) (8) is willing and able to share such information.

**Estimated Completion Date (13):** July 30, 2023 to initiate discussions with (b) (8) depending on (b) (8) availability. Discussions will be memorialized in a memorandum to the RMS Director from policy staff.

**Recommendation 14:** We recommend that the Director, RMS establish arrangements with other Federal agencies that administer Government-guaranteed loan programs to facilitate information sharing and proactive identification of risk.

**Planned Action (14):** Partially concur. RMS staff agree to take action consistent with the spirit of the recommendation; however, RMS staff do not fully control the ability to take action. Similar to the response in recommendation 13, by operation, information arrangements have to be agreed to by all parties, so the FDIC cannot unilaterally establish them. RMS staff infer by use of the word “other,” that this recommendation refers to agencies other than (b) (8). FDIC staff will contact (b) (6) to discuss the ability and willingness of these agencies to establish arrangements to facilitate information sharing.

**Estimated Completion Date (14):** July 30, 2023 to initiate discussions with (b) (8) depending on staff availability at the other agencies. Discussions will be memorialized in a memorandum to the RMS Director from policy staff.

**Recommendation 15:** We recommend that the Director, RMS develop and implement processes and procedures for the routine sharing, receipt, and storage of confidential information with Federal agencies that administer Government-guaranteed loan programs.

**Planned Action (15):** Partially concur. RMS staff agree to take action consistent with the spirit of this recommendation. Disclosure of FDIC confidential supervisory information is governed by Part 309 of the FDIC rules and regulations.<sup>21</sup> Section 309.6(b) (3) of the regulations contemplates disclosure to Federal financial institutions supervisory agencies and certain other agencies.

RMS staff note that this provision has been used to share information with (b) (8) in certain of the anonymized cases described in the draft report when there was good cause to do so.

RMS will issue an RD Memorandum describing procedures that comport with Part 309, for processing requests for confidential information by Federal agencies that administer government-

<sup>21</sup> 12 CFR 309.6(b) (3).

guaranteed lending programs. The RD Memorandum will also address, to the extent available, procedures for requesting confidential supervisory information from Federal agencies that administer GGL programs. The RD Memorandum will also describe procedures for documenting information sent or received in the FDIC's system of record.

**Estimated Completion Date (15):** January 31, 2024.

**Recommendation 16:** We recommend that the Director, RMS develop and implement guidance to provide instruction to FDIC bank examination staff requiring communication and information sharing with Federal agencies that administer Government-guaranteed loan programs to ensure FDIC staff and the Federal agencies are aware of any emerging risks.

**Planned Action (16):** Concur. The RD Memorandum described in recommendation 15 will set forth procedures for when it may be appropriate to communicate about emerging risks with Federal agencies that administer Government-guaranteed loan programs. These communications will be carried out by senior level FDIC management officials.

**Estimated Completion Date (16):** January 31, 2024.

**Recommendation 17:** We recommend that the Director, RMS determine whether other Federal agencies that administer Government-guaranteed loan programs have a list of FDIC-supervised banks with high risk factors associated with such programs and develop protocols to share information with relevant FDIC personnel, including examiners.

**Planned Action (17):** Concur. Again, FDIC staff is assuming "other" in this context means the agencies other than (b) (8). RMS staff note that the FDIC entered into the MOU with (b) (8) at (b) (8) request, and (b) (8) advised the FDIC of the information it sought on (b) (8) institutions. As described above, (b) (8) FDIC staff will contact (b) (8) to determine whether such lists are available and whether those agencies would be willing and able to share those lists. To the extent they are, then protocols will be established for sharing the lists.

**Estimated Completion Date (17):** July 30, 2023 for contacting other agencies to determine whether lists are available. Discussions will be memorialized in a memorandum to the RMS Director from policy staff.

**Recommendation 18:** We recommend that the Director, RMS develop and implement guidance to ensure relevant risk information exchanged with Federal Government agencies that administer Government-guaranteed loan programs is shared internally within the FDIC on an ongoing basis with the appropriate FDIC employees.

**Planned action (18):** Concur. The recommendation is consistent with past practice. With respect to (b) (8) and it did not provide a (b) (8) for 2020 pursuant to the MOU. (b) (8) did provide a (b) (8) in 2021, which was provided to the regional offices in December 2021, and was discussed in a call with the regional offices and

Washington in September 2021. The (b) (8) was provided by (b) (8) in December 2022, was provided to the regional offices in February 2023, and was discussed with the regional offices in March 2023. Procedures will be added to the RD Memorandum referenced in recommendation 15 to memorialize existing internal sharing procedures.

***Estimated Completion Date (18):*** January 31, 2024.

**Recommendation 19:** We recommend that the Director, RMS develop and implement updated FDIC examination guidance to establish an appropriate timeframe for uploading complete supervisory business records to RADD.

***Planned Action (19):*** Concur. RMS is in the process of developing and implementing updated guidance on the retention of workpapers, including establishing timeframe for uploading supervisory records to its system of record.

***Estimated Completion Date (19):*** December 31, 2023.

## Appendix A

## Select Publicly Available Resources Related to the Paycheck Protection Program

- 3/13/2020 - US Declares a National Emergency due to Covid- [Proclamation on Declaring a National Emergency Concerning the Novel Coronavirus Disease \(COVID-19\) Outbreak](#)
- 3/13/2020 - FDIC issued a statement encouraging banks to work with borrowers [FIL-17-2020 Regulatory Relief: Working with Customers Affected by the Coronavirus](#)
- 3/19/2020 - [FIL-18-2020 Frequently Asked Questions For Financial Institutions and Consumers Affected by the Coronavirus](#)
- 3/27/2020 - *Legislation*: [CARES Act](#) is enacted - PPP Commitment - \$349B (Round One)
- 3/30/2020 - FDIC adds a PPP resource page at FDIC.gov <https://www.fdic.gov/Coronavirus/smallbusiness>
- 3/31/2020 - [US Treasury: PPP Lenders - Information Fact Sheet](#)
- 4/1/2020 – Letter from Independent Community Bankers Association to SBA and US Treasury regarding concerns about PPP, including lender liability <https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-regulators/icba-letter-to-treasury-sba-regarding-concerns-with-paycheck-protection-program>
- 4/2/2020 – SBA and US Treasury issue PPP - [Interim Final Rule PPP](#)
- 4/2/2020 - [FIL-33-2020 Revised: New SBA and Treasury Programs Available for Small Business Relief](#)
- 4/6/2020 - [Press Release: Federal Reserve will establish a facility to facilitate lending to small businesses via the Small Business Administration's Paycheck Protection Program \(PPP\) by providing term financing backed by PPP loans](#)
- 4/7/2020 – [FIL-36-2020 Revised Interagency Statement on Loan Modifications by Financial Institutions Working with Customers Affected by the Coronavirus](#)
- 4/9/2020 – [FIL-37-2020 Changes to the Regulatory Capital Rule to Accommodate the Paycheck Protection Program](#)
- 4/9/2020 - [Press Release: Federal Bank Regulators Issue Interim Final Rule for Paycheck Protection Program Facility](#)
- 4/16/ 2020 – [Press Release: Statement by Secretary Mnuchin and Administrator Carranza on the Paycheck Protection Program and Economic Injury Disaster Loan Program](#) -the SBA closed the PPP after exhaustion of the \$349 billion appropriated.
- 4/22/2020 - FRB issues IFR that exempts certain loans guaranteed under the PPP from Regulation O - [Federal Register: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks](#)
- 4/23/2020 – [FIL-49-2020 Banker Webinar: How to Become a PPP Lender](#)
- 4/24/2020 - [Joint Statement by SBA Administrator Jovita Carranza and Treasury Secretary Steven T. Mnuchin on the Resumption of the Paycheck Protection Program](#)
- 4/24/2020 – *Legislation* - [Paycheck Protection Program and Health Enhancement Act](#)  
PPP commitment increased to \$659 Billion (Round Two)

- 4/25/2020 - [FIL-50-2020 Small Business Administration \(SBA\) and U.S. Department of Treasury Announce Availability of New Paycheck Protection Program Loans](#)
- 5/5/2020 - [Press Release: Federal Bank Regulatory Agencies Modify Liquidity Coverage Ratio For Banks Participating in Money Market Mutual Fund Liquidity Facility and Paycheck Protection Program Liquidity Facility](#)
- 5/12/2020 - [FIL-56-2020 - Proposed Rulemaking to Mitigate the Deposit Insurance Assessment Effects of Participation in the Paycheck Protection Program \(PPP\), the PPP Lending Facility, and the Money Market Mutual Fund Liquidity Facility](#)
- 5/30/2020 - [Frequently Asked Questions \(FAQs\) on the SBA's PPP](#)
- 6/12/2020 - [FIL-60-2020 Revisions to the Consolidated Reports of Condition and Income \(Call Report\) and the FFIEC 101 Report](#)
- 6/22/2020 - [FIL-63-2020 - Final Rule Mitigating the Deposit Insurance Assessment Effect of Participation in the PPP, PPPLF, and the MMLLF](#)
- 6/23/2020 - [FIL-64-2020 Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic on Financial Institutions](#)
- 7/4/2020 - This bill extends PPP application period from June 30<sup>th</sup> through August 8, 2020, [Bill to extend the authority for commitments for the PPP and separate amounts authorized for other loans under section 7\(a\) of the SBA, and for other purposes](#)
- 7/28/2020 - [Advisory Committee on Community Banking Meeting Minutes - July 28, 2020](#) Members discussing their banks' participation in PPP.
- 9/3/2020 - [FIL-87-2020 Banker Webinar: Loan Forgiveness and Other Matters Relative to the PPP](#)
- 9/10/2020 - [Webinar - Community Affairs Events](#) FDIC Alliance for Economic Inclusion (AEI) Hosts Banker Roundtable on COVID-19 Small Business Investment Fund Opportunities in Los Angeles, CA.
- 9/29/2020 - [FIL-93-2020 - Treatment of Certain Emergency Facilities in the Regulatory Capital Rule and the Liquidity Coverage Ratio Rule](#)
- 10/20/2020 - [FIL-99-2020 The FDIC Approves Interim Final Rule to Provide Temporary Relief from Part 363 Audit and Reporting Requirements](#)
- 10/28/2020 - [Advisory Committee on Community Banking Meeting Minutes - October 28, 2020](#) - SBA provided an update and fielded questions regarding PPP.
- 11/19/2020 - [FDIC Hosts Podcast: Community Banks and the Paycheck Protection Program](#)
- 11/20/2020 - [FIL-108 - Interagency IFR provides Regulatory Relief to Institutions Experiencing Temporary Asset Growth in Connection with COVID-19-Related Programs](#)
- 12/27/20 - Legislation - [Consolidated Appropriations Act, 2021](#) - PPP Commitment increased to \$806.4 Billion (Round Three)
- 1/8/2021 - [Press Release: SBA and Treasury Announce PPP Re-Opening; Issue New Guidance](#)
- 1/11/2021 - [FIL-01-2021 Banker Webinar: Basics of New PPP Loan Programs](#)
- 1/11/2021 - [Press Release: SBA Re-Opens PPP to Community Financial Institutions First](#)

- 3/11/2021 - *Legislation:* [The American Rescue Plan Act of 2021](#) This bill provides additional relief due to COVID-19; PPP Commitment increased to \$813.7 Billion [Press Release: American Rescue Plan Act Elevates Small Business Support in Response to COVID-19 Pandemic](#)
- 3/31/2021 – *Legislation:* [PPP Extension Act of 2021](#) - This bill extends PPP from March 31, 2021 to June 30, 2021.
- 4/13/2021 - [Advisory Committee on Community Banking Meeting Minutes April 13, 2021](#) - Members discussing their banks' participation in PPP.
- 6/1/2021 – [Press Release: SBA Administrator Issues Statement on the Closure of Paycheck Protection Program](#) Final SBA approved loans \$799.8Billion. SBA Report: [Paycheck Protection Program \(PPP\) Report: Approvals through 05/31/2021](#)

This table presents management's response to the recommendations in the report and the status of the recommendations as of the date of report issuance.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved: <sup>a</sup> Yes or No	Open or Closed <sup>b</sup>
1	RMS will update the RMS Manual to ensure that examination guidance on Government-guaranteed loan risks and activities, including the assessment of loan classifications, concentrations, and off-balance sheet risk is comprehensive and centralized for better access.	January 31, 2024	\$0	Yes	Open
2	RMS will update the RMS Manual to ensure that examination guidance on Government-guaranteed loan risks and activities, including the assessment of loan classifications, concentrations, and off-balance sheet risk is comprehensive and centralized for better access.	January 31, 2024	\$0	Yes	Open
3	RMS will update the Examination Profile Script List to include additional questions to identify bank participation in Government-guaranteed loans.	September 30, 2023	\$0	Yes	Open
4	Consistent with its risk-focused approach, the FDIC will instruct examiners-in-charge to include on Safety and Soundness Request Lists, a request that bank management identify Government-guaranteed loans and provide relevant risk and risk management related information, as appropriate.	September 30, 2023	\$0	Yes	Open
5	The RMS Director will issue an RD Memorandum with an operating procedure that requires Washington Office policy staff to develop a risk assessment on future Government-guaranteed loan programs involving FDIC-insured and FDIC-supervised institutions that will include an assessment of applicable risks, including fraud risk.	January 31, 2024	\$0	Yes	Open
6	The RD Memorandum described in recommendation 5 will require that future guidance include all risks associated with future Government-guaranteed loan programs and have instructions to allow for consistency in supervisory activities.	January 31, 2024	\$0	Yes	Open

7	RMS will update its June 2020 RD Memorandum to describe existing procedures for heightened monitoring for banks with remaining exposures. The Memorandum will refer to existing communications protocols and discussions with regulators to communicate observed weaknesses and will emphasize the importance of expanding reviews when existing AML/CFT controls display weaknesses.	May 31, 2023	\$0	Yes	Open
8	RMS will coordinate with the other Federal bank regulators and determine whether revisions are needed to FDIC guidance and practices for assessing concentrations and loan classification to ensure uniform application of supervisory approaches with the other Federal regulators.	January 31, 2024	\$0	Yes	Open
9	RMS will discuss supervisory approaches to banks regarding concentrations and loan classification with the other Federal bank regulators.	January 31, 2024	\$0	Yes	Open
10	RMS will develop and provide training consistent with the planned updates to the RMS Manual, Examination Profile Script, and Examiner Request List.	March 31, 2024	\$0	Yes	Open
11	RMS will develop and distribute a list of employees that have specialized experience in Government-guaranteed loan programs.	September 30, 2023	\$0	Yes	Open
12	RMS will provide a link on its internal webpage to (b) (8) [REDACTED], which contains portfolio information for its various Government-guaranteed loan programs. RMS will also work with the Division of Insurance and Research to identify other reports that may be helpful to examiners.	June 30, 2023	\$0	Yes	Open
13	RMS will initiate discussions with (b) (6) [REDACTED] to determine whether loan portfolio information as described in the recommendation is available for (b) (8) [REDACTED] and whether (b) (6) [REDACTED] is willing and able to share such information.	July 30, 2023	\$0	Yes	Open
14	The FDIC will contact the other agencies mentioned in the OIG's report to discuss the ability and willingness of these agencies to	July 30, 2023	\$0	Yes	Open

	establish arrangements to facilitate information sharing.				
15	RMS will issue an RD Memorandum describing procedures for processing requests for confidential information by, and requesting confidential supervisory information from, Federal agencies that administer Government-guaranteed loan programs. The RD Memorandum will also describe procedures for documenting information sent or received in the FDIC's system of record.	January 31, 2024	\$0	Yes	Open
16	The RD Memorandum described in recommendation 15 will set forth procedures for when it may be appropriate to communicate about emerging risks with Federal agencies that administer Government-guaranteed loan programs.	January 31, 2024	\$0	Yes	Open
17	The FDIC will contact other Federal Agencies that administer Government-guaranteed loan programs to determine whether such lists are available and whether those agencies would be willing to share those lists. In such cases, protocols will be established for sharing the lists.	July 30, 2023	\$0	Yes	Open
18	RMS will add procedures to the RD Memorandum referenced in recommendation 15 to memorialize existing internal sharing procedures.	January 31, 2024	\$0	Yes	Open
19	RMS will develop and implement updated guidance on the retention of workpapers, including establishing a timeframe for uploading supervisory records to its system of record.	December 31, 2023	\$0	Yes	Open

<sup>a</sup> Recommendations are resolved when —

1. Management concurs with the recommendation, and the OIG agrees the planned corrective action is consistent with the recommendation.
2. Management does not concur or partially concurs with the recommendation, but the OIG agrees that the proposed corrective action meets the intent of the recommendation.
3. For recommendations that include monetary benefits, management agrees to the full amount of OIG monetary benefits or provides an alternative amount and the OIG agrees with that amount.

<sup>b</sup> Recommendations will be closed when the OIG confirms that corrective actions have been completed and are responsive.



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