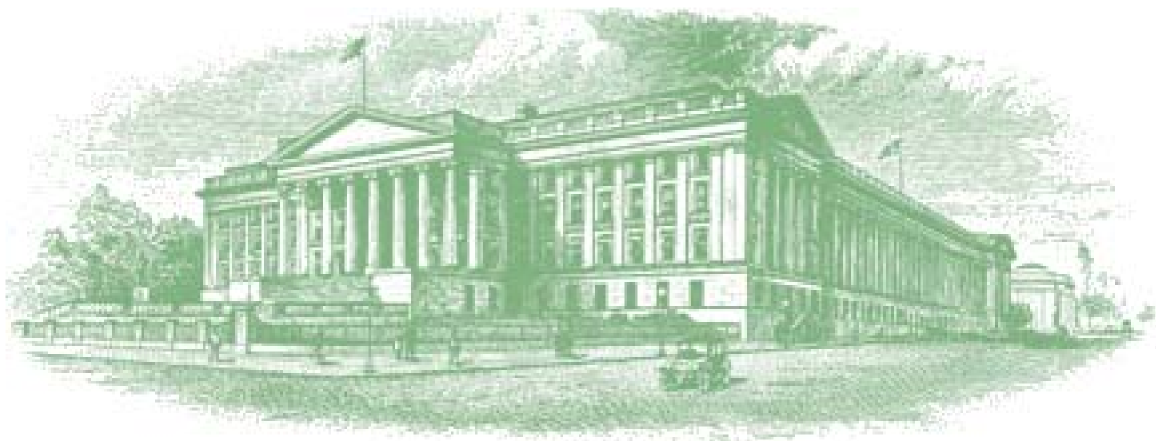
Audit Report



OIG-06-045

OCC: Allegations Regarding Supervision of National Family Bank

September 27, 2006

Office of Inspector General

Department of the Treasury

Contents

Appendices

Abbreviations

OIG	Office of Inspector General
OCC	Office of the Comptroller of the Currency
MRA	Matters Requiring Attention
ROE	Report of Examination

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September 27, 2006

John C. Dugan
Comptroller of the Currency
Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency's (OCC) mission is to supervise national banks. OCC's supervisory activities encompass bank examinations and enforcement activities, dispute resolution, ongoing monitoring of banks, and analysis of systemic risk and market trends. Headquartered in Washington, D.C., OCC has four district offices, plus an office in London to supervise the international activities of national banks.

On November 7, 2005, our office received a complaint from the majority owner and Chairman of the Board of National Family Bank, of Munden, Kansas (hereafter referred to as the Complainant). The Complainant expressed concern about how OCC was conducting its supervisory activities of National Family Bank prior to the sale of the bank in December 2004.

Our objectives were to determine whether OCC conducted its supervisory activities of National Family Bank in accordance with OCC policies and procedures and whether there was merit to the concerns expressed by the Complainant with respect to OCC's supervisory conduct.

We reviewed correspondence provided to us by the Complainant; obtained and reviewed OCC's policies and procedures related to its supervision of community banks; and obtained and reviewed OCC's examination reports and supervisory workpapers and other OCC documentation related to National Family Bank. Appendix 1 contains a more detailed description of our objectives, scope, and methodology.

Results in Brief

Our review addresses four allegations made by the Complainant related to OCC's supervisory activities of National Family Bank prior to the sale of the bank in December 2004 by the Complainant. The Complainant made the following allegations:

- Throughout the 2003 and 2004 supervisory cycle, the OCC Examiner was prejudiced and communicated with the bank's President rather than the then-Chairman of the Board (the Complainant) regarding problems with bank management and operations.
- The OCC Examiner did not tell the Complainant that bank employees needed training.
- Prior to OCC's 2003 full-scope examination[1] of the bank, OCC did not find any significant problems related to lack of documentation, disorderly loan files, or employee inefficiency.
- The OCC Examiner's Office applied pressure tactics to force the Complainant to sell the bank.

Based on our review, we have concluded that the allegations are without merit. Appendix 3 contains a detailed presentation of OCC's documentation of its supervisory activities of National Family Bank and of is policies and procedures as they relate to the allegations.

We also found that OCC did not adhere to its policy to obtain and keep a receipt from the management of National Family Bank acknowledging management's review of OCC's 2003 Report of Examination (ROE) by the Board of Directors. OCC should consider reminding its staff to retain such receipts for all ROEs.

[1] A full-scope examination is sufficient to assess the bank's composite and component CAMELS ratings and make a conclusion about the bank's risk profile. CAMELS is an acronym for the six component elements that are evaluated: Capital, Assets, Management, Earnings, Liquidity and Sensitivity to risk.

Background

On March 15, 2000, the Munden State Bank, a state-chartered bank, became National Family Bank, a nationally chartered bank, and changed its primary regulatory agency from the Federal Deposit Insurance Corporation to OCC.[2]

OCC's Kansas City North Field Office was responsible for supervising National Family Bank. OCC supervised and examined National Family Bank using procedures designed for community banks. Community banks are generally defined as banks with less than $1 billion in total assets. OCC's supervision of community banks is designed to do the following:

- Determine the condition of the bank
- Evaluate the overall integrity and effectiveness of risk management systems
- Determine compliance with banking laws and regulations
- Communicate findings, recommendations, and requirements to bank management and directors in a clear and timely manner, and obtain informal or formal commitments to correct significant deficiencies
- Verify the effectiveness of corrective actions or, if actions have not been undertaken or accomplished, pursue resolution through appropriate supervisory or enforcement actions

A key component of OCC's supervisory process is the ROE. OCC must provide a bank's Board of Directors a ROE once every supervisory cycle, which, depending on the risk profile of the bank, ranges from 12 to 18 months. The ROE communicates the overall condition and risk profile of the bank, and it summarizes the examiner's activities and related findings conducted throughout the supervisory cycle. Examiners are required to detail significant deficiencies and excessive risks, along with the corrective action to which the Board or management has committed, in the ROE's

[2] Banks in the United States have the option of being chartered by either the state or the Federal government. State chartered banks are regulated by both the state regulatory agency and the FDIC. Federally charted banks are regulated by the OCC.

Matters Requiring Attention (MRA) section. OCC conducted its first full-scope examination of National Family Bank in 2001.

The OCC Examiner whose conduct the Complainant has questioned began supervising National Family Bank in 2003. The Examiner first met with bank management in July 2003 to discuss ongoing supervision of the bank.

In February 2004, as part of its supervisory cycle, OCC conducted a full-scope examination of National Family Bank as of September 30, 2003 (the resulting report is referred to hereafter as the 2003 ROE). The 2003 ROE was performed by the Examiner whose conduct the Complainant has questioned. The findings contained in the 2003 ROE are central to the Complainant's allegations.

Finding

Finding 1 OCC Was Unable to Provide a Signature Page or Receipt for National Family Bank's September 30, 2003, Report of Examination

As part of our review, we obtained the ROEs prepared for National Family Bank from 2001 through 2004 to determine if the bank's Board of Directors had signed each ROE. OCC's Kansas City North Field Office, which has supervisory responsibility for National Family Bank, was able to provide for our review either a signed signature page or signed receipt indicating that the bank's Board of Directors had reviewed the 2001, 2002, and 2004 ROEs. However, OCC was unable to obtain from the bank's current owners a copy of the signature page of the 2003 ROE. In addition, staff in the field office had not obtained and maintained a signed receipt from the bank's management signifying that its Board of Directors had reviewed the 2003 ROE[3]. Because OCC was unable to provide either a signed signature page or receipt for the 2003 ROE, we were unable to confirm that members of the Board of Directors reviewed the 2003 ROE when OCC provided it to them at the end of the examination, in February 2004.

[3] The MRAs contained in the 2003 ROE are central to the allegations addressed by this report.

The ROE requires that national bank directors, in keeping with their responsibilities to depositors and shareholders, thoroughly review ROEs prepared for their bank. After they complete their review, directors are to sign the signature form attached to the report. According to OCC guidelines, examiners are to include the "Signature of Directors" page in all ROEs.[4] The signature page, which is the last page of the ROE, states that the page should remain attached to the ROE and be retained in the institution's file for review during subsequent examinations. Additionally, to verify that the Board of Directors has reviewed the ROE, it is OCC's policy to request a receipt signed by the bank's President or Cashier. By signing the receipt, bank management acknowledges that the Board of Directors has reviewed the ROE.

Officials in OCC's Kansas City North Field Office were unable to explain why the signature page was not at the bank. According to the bank's new owners, they received all records from the prior owner; thus, if the signature page did exist, it was not transferred along with ownership of the bank. Additionally, OCC officials were unable to explain why the receipt was not in the bank's file at OCC. OCC acknowledges that it did not follow its normal procedures to ensure that a signed receipt for the 2003 ROE was obtained and retained.

Without evidence of Board of Director review of ROEs, OCC may find it difficult to refute allegations – such as those made in this case by National Family Bank with respect to the 2003 ROE – that Board members were not made aware of OCC findings. In this case, however, National Family Bank had entered into a commitment letter with OCC on April 14, 2004, which was in OCC's supervisory records for the bank that specifically referenced problems cited in the 2003 ROE.

The commitment letter had been signed by all members of the bank's Board of Directors, indicating that they were aware of the problems that OCC had found. Without this signed commitment letter, OCC would have no evidence external to the OCC supervisory database to demonstrate that the bank's Board of

[4] OCC, *Comptroller's Handbook*, "Community Bank Supervision" (July 2003), app. C.

Directors had been made aware of the problems cited in the 2003 ROE. Given our review was focused on a single bank we are not making a formal recommendation, but would encourage OCC to remind its staff to retain receipts from banks' management acknowledging their reviews of ROEs.

* * * * * *

We would like to extend our appreciation for the cooperation and courtesies extended to our staff during this review. If you have any questions, please contact me at (202) 927-0382 or Valerie A. Freeman, Audit Manager, at (202 927-0503. Major contributors to this report are listed in appendix 3.

Alain Dubois
Director, Banking Audits

Our objectives were to determine if the OCC examiner was communicating with the President of National Family Bank rather than the Chairman of the Board, whether National Family Bank's Board of Directors received any information concerning the need to implement a staffing and training plan, and if OCC applied pressure tactics to force the Complainant to sell National Family Bank.

To determine if the OCC examiner was improperly communicating with the President of National Family Bank rather than the Chairman of the Board regarding problems with the management and operations of the bank, we reviewed (1) supervisory workpapers and other documentation provided by OCC associated with National Family Bank, (2) OCC's ROEs for its fiscal years 2001 through 2004 examinations of National Family Bank, and (3) OCC's policies and procedures pertaining to supervisory communication with a bank's management and board of directors.

To determine if National Family Bank's Board of Directors received any information from OCC regarding inadequacies in the training of bank employees, we reviewed (1) supervisory workpapers and other documentation provided by OCC associated with National Family Bank, (2) OCC's ROEs for its fiscal years 2001 through 2005 examinations of National Family Bank, and (3) OCC's policies and procedures pertaining to supervisory communication with a bank's management and board of directors.

To determine if OCC applied pressure tactics to force the Complainant to sell National Family Bank, we reviewed (1) supervisory workpapers and other documentation provided by OCC associated with National Family Bank, (2) OCC's ROEs for its fiscal years 2001 through 2005 examinations of National Family Bank, and (3) OCC's policies and procedures pertaining to enforcement actions against a national bank.

Because OCC's documentation of its supervisory activities of National Family Bank was sufficient, competent, and relevant to support our conclusions, and the ROEs and the April 2004 commitment letter were acknowledged by the Board of Directors, including the Complainant, we determined there was no need to interview either OCC staff that conducted the examinations or the Complainant.

The Complainant questioned the conduct of the bank's President; specifically, the Complainant alleged that the President of National Family Bank did not call or contact him when he was Chairman of the Board regarding questions related to management functions and problems at the bank. In the context of our review, we considered communications between the President of National Family Bank and the bank's Board of Directors to be internal to the bank and the responsibility of Board of Directors. As a result, such communications were not included in the scope of our review.

We conducted our audit from December 2005 to July 2006 in accordance with generally accepted government auditing standards.

Allegation 1: The OCC Examiner Communicated With the President of National Family Bank Rather Than the Chairman of the Board Regarding Problems with the Management and Operations of the Bank

The Complainant asserted that throughout the 2003 and 2004 supervisory cycle, the OCC examiner was prejudiced and communicated with the bank's President, rather than the Chairman of the Board, regarding problems with the management and operations of the bank.

Based on our review of the supervisory workpapers and other documentation provided by OCC for National Family Bank, we found that OCC communicated information related to its supervisory activities to the management and Board of Directors as required by OCC policies and procedures. The OCC Examiner engaged in regular communications with National Family Bank's President and the Complainant regarding problems with management and operations identified by OCC during periodic monitoring activities conducted throughout 2003 and 2004, including MRAs identified as a result of the 2003 full-scope examination.

The OCC community bank supervision handbook[5] states that OCC is committed to continual and effective communication with the banks that it supervises. Based on such direction, it was incumbent upon the OCC Examiner for National Family Bank to be in contact with bank management throughout the supervisory process. When examiners find significant weaknesses or excessive risks, they are required to thoroughly discuss the issues with bank management and the Board of Directors.

According to OCC guidance, periodic meetings with bank management are essential during the examination process. At the beginning of an examination, the examiner is required to meet with the bank's chief executive officer, appropriate members of senior

[5] OCC, *Comptroller's Handbook*, "Community Bank Supervision" (July 2003).

management, or Board members to again explain the scope and objectives of the examination. The OCC guidance states that during the examination, discussion of key issues and preliminary findings with bank management will prevent misunderstanding and allow bank management to provide additional information to OCC. In addition, the examiner is required to conduct an exit meeting with appropriate bank management officials when the examination is completed. During this meeting, the examiner is to rank the issues identified in the examination by order of importance to help management understand which areas present the most risk to the bank.

The ROE is OCC's primary vehicle for communicating in writing major examination conclusions, including any significant problems and actions needed to address them. OCC provides a draft report containing the examination conclusions and MRAs to bank management to review for accuracy. After the board, or a committee authorized by the board, has had the opportunity to review the draft report, the Examiner is required to meet with the bank's board of directors. In addition, an OCC supervisory office official or designee is required to attend the board meeting.

At the board meeting, the examiner is required to describe the following:

- The objectives of OCC's supervision and how OCC pursues those objectives
- Strategic issues, including growth, products, and strategies
- Major concerns or issues, including significant risks facing the bank
- The bank's success or failure in correcting previously identified deficiencies
- The impact of failing to correct deficiencies
- What OCC expects the bank to do and when (i.e., action plans, supervisory strategies, and commitments)
- What the bank is doing well
- Industry issues affecting the bank

In January 2004, as part of its supervisory cycle, OCC began a full-scope examination of National Family Bank as of September 30, 2003 (the resulting report is referred to hereafter as the 2003 ROE). OCC found the following:

- Supervision of bank activities by the Board and management needed improvement.
- The internal control structure at the bank was very weak.
- The call report preparation process needed improvement.
- The internal audit function needed improvement.
- The bank's information technology function was less than satisfactory.

In the 2003 ROE, OCC communicated its concerns regarding National Family Bank's control environment and supervision of bank activities by the Board and management to the bank's Board of Directors. OCC found that the weaknesses it identified during its full-scope examination and reported in the 2003 ROE required aggressive action by management and the Board of Directors. OCC conducted an exit meeting on February 6, 2004, to discuss the conclusions in the 2003 ROE. OCC also communicated the conclusions the Board of Directors at a meeting held February, 25, 2004, at which all of the Directors were present. The Board was in agreement that the control environment weaknesses identified by OCC and reported in the ROE needed to be addressed. The Board was also in agreement with the downgrade of the management and information technology components of the bank's CAMELS[6] ratings from 2 to 3.

A 3 rating for the management component of the CAMELS rating indicates that management and Board performance need improvement or that risk management practices are less than satisfactory given the nature of the institution's activities. A 3

[6] The Uniform Financial Institutions Rating System, called CAMELS, was adopted by the Federal Financial Institutions Examination Council on November 13, 1979. CAMELS is used to evaluate the safety and soundness of a savings association or bank. In addition to the six component elements that make up the CAMELS acronym, which are each rated on a scale of 1 to 5 (with 1 being the best and 5 being the worst), OCC provides a separate rating for an additional element, Information Technology.

rating for information technology indicates the financial institution's information technology raises some degree of supervisory concern.

As a result of the 2003 ROE, OCC asked the Board to sign a commitment letter[7] that included the control weaknesses OCC identified and the corrective actions the Board of Directors agreed to take to address them. The Board of Directors agreed with OCC's request and signed the commitment letter in April 2004.

The OCC community bank supervision handbook provides for periodic monitoring of banks supervised by OCC. Periodic monitoring activities are a key component of OCC's supervision of national banks. For a majority of national banks, OCC prefers that examiners maintain some type of quarterly contact. Depending on the circumstances and the bank's risk profile, periodic monitoring activity by OCC could be as limited as a brief phone call to bank management or could be extended to include a review of bank financial information or a visit to the bank.

As part of its supervisory activity, OCC conducted quarterly monitoring activities that included ongoing discussions with management of National Family Bank on the progress the bank was making to address the weaknesses covered in the commitment letter. The monitoring activities also included meeting with the Board of Directors in June 2004 and performing an on-site review at the bank in September 2004. OCC communications with management of National Family Bank included weekly telephone conversations, written correspondence such as examination and on-site monitoring engagement letters, and entrance and exit meetings held in relation to the on-site monitoring activities.

Other communications between OCC and the bank included November 2, 2004, OCC correspondence finding National Family Bank in noncompliance with its April 2004 commitment letter and phone conversations with the bank's President, the Complainant, and other bank staff after the resignation of the President on

[7] A commitment letter is a document signed by the bank's Board of Directors on behalf of the bank and acknowledged by an authorized OCC official that reflects specific written commitments to take corrective actions in response to problems or concerns identified by OCC in its supervision of the bank.

November 29, 2004, due, according to him, to his deteriorating relationship with the Complainant.

It should also be noted that the President who held office from October 10, 2003, through November 29, 2004, arrived with no experience in the day-to-day management of a bank and that the Board of Directors instructed him to seek assistance from both the OCC Examiner and the Board of Directors with respect to banking matters. Our review of OCC supervisory documentation indicated that OCC was concerned about the lack of communication between the bank's President and the Complainant. The President admitted that there was a communication problem because he found the Complainant difficult to work with. OCC noted in its supervisory documentation that when questioned about the lack of communication between the Complainant and the bank's President, the Complainant became defensive and blamed the President for not keeping him informed.

OCC requires that the details of its meetings and discussions with bank personnel be documented in OCC's supervisory information database. We found that OCC documented its communications with the management and Board of Directors of National Family Bank regarding its oversight and supervisory activities in OCC's supervisory database in accordance with its policies and procedures.

We therefore concluded that (1) communications between the OCC Examiner and the bank's President would occur as a normal part of OCC's supervisory process; (2) during its communications with National Family Bank management during the 2003-2004 supervisory cycle, OCC adhered to its policies and procedures for communicating with bank management; and (3) OCC documented its communications with the management and Board of Directors of National Family Bank regarding its oversight and supervisory activities in the OCC supervisory database in accordance with OCC policies and procedures. Consequently, we found this allegation to be without merit.

Allegation 2 OCC Did Not Communicate the Need to Establish a Staffing and Training Plan to National Family Bank

The Complainant alleged that National Family Bank's Board of Directors did not receive any information regarding training or lack thereof of bank employees. He stated that if there were any concerns about staff training, OCC should have relayed the concern directly to him. Our review found strong evidence that OCC informed the Board of Directors of National Family Bank about the need to establish a staffing and training plan. Thus, our review did not substantiate the Complainant's allegation.

According to *The Directors Book: The Role of a National Bank Director*,[8] one of the Board's fundamental responsibilities is to select and retain competent management. The Board is required to verify that the bank has adequate training programs to support needed skill levels and to keep personnel up to date with developments in the financial services industry. The Board may depend on management's expertise to run the bank's daily operations, but the Board remains ultimately responsible for monitoring the bank's operations.

The *Comptroller's Handbook*, "Community Bank Supervision," requires that when examiners find significant weaknesses or excessive risks, they are required to thoroughly discuss the issues with bank management and the Board of Directors and include such matters in the ROE.

OCC's 2003 ROE communicated to the Board of Directors the need for the bank to train its staff and develop a staffing plan. OCC reported in the ROE that Family National Bank lacked an effective training program to educate and involve employees in the internal control structure of the bank. OCC recommended that the Board develop and implement a staffing plan consistent with the objectives contained in the bank's strategic plan. OCC also

[8] OCC, *The Director's Book: The Role of a National Bank Director* (March 1997).

recommended that the Board direct any changes necessary to provide the bank with a staff that possessed the skills and expertise needed. OCC presented the content of the 2003 ROE, which contained these findings and recommendations, to the Board of Directors at a Board meeting held February 25, 2004.

The April 2004 commitment letter provided in response to the 2003 ROE included provisions for the Board to develop and implement a staffing plan and to direct any changes necessary to provide the bank with a staff that possessed the skills and expertise needed. The Board of Directors, including the Complainant, agreed to these actions, as evidenced by their signatures on the commitment letter.

OCC further communicated the need for training and a staffing plan to the Board of Directors during two follow-up meetings. In June 2004 OCC met with the Board to specifically discuss the progress the bank had made on implementing corrective actions contained in the commitment letter. At this meeting, OCC stressed that the Board, not the bank's President, was responsible for addressing the staffing issue. OCC met with the Board again in October 2004 at the conclusion of an on-site supervisory visit conducted to follow up on the progress the Board had made on the commitment letter. OCC noted in its supervisory documentation that it had obtained a commitment from the Board to improve employee training at this meeting.

We therefore concluded that OCC informed the National Family Bank Board of Directors, including the Complainant, about the need to establish a staffing and training program. Consequently, we found this allegation to be without merit.

Allegation 3 Prior OCC Examinations Did Not Identify Problems with National Family Bank's Management

The Complainant alleged that OCC's 2001 and 2002 examinations of National Family Bank, did not reveal any significant problems related to lack of documentation, disorderly loan files, or employee inefficiency[9]. We found, however, that prior ROEs for National Family Bank called for improvement in management and Board performance, including, for example, significant management issues related to National Family Bank's leasing portfolio during the 2001 examination. OCC noted that the management and Board of National Family Bank relied heavily on the Complainant to oversee the leasing portfolio. OCC also noted that although the Complainant was knowledgeable about leasing activities in general, he was unable to provide documentation of a servicing agreement with the bank's loan servicer and was unable to readily respond to questions about the status of the written servicing agreements. Further review of the leasing portfolio led OCC to determine that the bank had violated its legal lending limit. Because OCC was concerned about inadequate management of the leasing activities, it decided to downgrade the management component of the bank's CAMELS rating from 2 to 3, indicating that management and Board performance needed improvement.

At a Board meeting held December 12, 2001, to discuss the results of the examination, OCC informed the Board of Directors that the bank was on the verge of being considered a problem institution and that any material decline in asset quality could result in a downgrade of the composite CAMELS rating to a 3 to highlight OCC's supervisory concerns with the bank.[10] The Board of Directors, including the Complainant, did not dispute these facts or the downgrade in the management component of the CAMELS rating. To help the Board resolve the problems it identified, OCC referred the Board to several OCC publications that would help the Board perform its duties and correct the problems noted in the 2001 ROE.[11]

In its 2002 ROE, OCC found that the Board and management had successfully corrected the deficiencies involving the unsatisfactory

[9] These exams were not conducted by the examiner that conducted the 2003 examination.
[10] Such financial institutions require more than normal supervision, which may include formal or informal enforcement actions.
[11] At the time OCC referred the Board to the following OCC publications: *OCC Handbook Community Supervision,* (August 2001)*; Detecting Red Flags in Board Reports, A Guide for Directors* (September 2000); and *Internal Controls, A Guide for Directors* (September 2000).

administration of purchased leases and the related legal lending limit violation. At that time, OCC found that the Board and management were adequately overseeing and supervising the bank and, as a result, upgraded the management component of the bank's CAMELS rating from 3 to 2.

Our review found that prior OCC examinations identified problems with National Family Bank's management. Consequently, we found this allegation to be without merit.

Allegation 4 OCC Applied Pressure on National Family Bank to Force the Complainant to Sell the Bank

The Complainant asserts that he was forced to sell National Family Bank because of the actions of the OCC Examiner, specifically, that pressure tactics were applied by the Examiner's Office.

The OCC *Policies and Procedures Manual*[12] prescribes the enforcement actions available to OCC, which fall into two broad categories – informal and formal. When a bank's overall condition is sound, but it is necessary to obtain written commitments from its Board of Directors to ensure that identified problems will be corrected, OCC may use informal corrective actions. Informal enforcement actions include commitment letters, memoranda of understanding, and approved safety and soundness plans.[13] Unlike most informal actions, formal enforcement actions are authorized by statute, are generally more severe than informal enforcement actions, and are disclosed to the public. Formal actions against a bank include orders and formal written agreements, prompt corrective action, and safety and soundness orders.

In the event it finds weaknesses or failures at a national bank, OCC is required to take supervisory actions to correct deficiencies and return the bank to a safe and sound condition as soon as possible.

[12] OCC, *Policies and Procedures Manual*, Enforcement Action Policy, 5310-3-(REV) (July 30, 2001).
[13] Pursuant to 12 C.F.R. Part 30, Safety and Soundness Standards, OCC may, based on an examination, inspection, or any other information that becomes available to it, determine that a bank has failed to satisfy the safety and soundness standards. If OCC determines that a bank has failed a safety and soundness standard, OCC may request, by letter or through an ROE, submission of a compliance plan.

Enforcement actions are intended to ensure that the Board of Directors implements corrective actions specified in agreements, such as commitment letters, between OCC and a bank.

Determining whether an informal action is the appropriate response, and deciding upon which informal action to use, depends on (1) the overall condition of the bank (both current and projected); (2) the nature, extent, and severity of the bank's problems and weaknesses; and (3) whether the bank's Board and management demonstrate the commitment and ability to correct the identified problems and weaknesses within an appropriate timeframe. OCC may approve the use of certain informal enforcement actions, such as a commitment letter, on banks with a composite CAMELS rating of 1 or 2.

OCC found that the weaknesses identified in the 2003 ROE required aggressive action by National Family Bank's management and Board of Directors. OCC determined that asking the Board to sign a commitment letter was the appropriate enforcement action to ensure the Board would address the identified weaknesses within an agreed-upon timeframe.

A commitment letter is a document signed by a bank's Board of Directors on behalf of the bank and acknowledged by an authorized OCC official that contains specific written commitments to take corrective actions in response to problems or concerns identified by OCC in its supervision of the bank. Once problems or weaknesses are identified and communicated to the bank, the bank's senior management and Board of Directors are expected to promptly correct them. A commitment letter is not a binding legal document, but failure to honor the commitments provides strong evidence of a need for formal action.

National Family Bank's Board of Directors, including the Complainant, reviewed, discussed, and signed a commitment letter in April 2004. The letter contained a provision for the bank to adopt, implement, and adhere to a strategic plan covering at least a

3-year period.[14] The strategic plan was to establish objectives for the bank's overall risk profile, earnings performance, growth, balance sheet mix, off-balance-sheet activities, liability structure, capital adequacy, reduction of volume of nonperforming assets, and product line development and market segments that the bank intends to promote or develop, together with strategies to achieve those objectives.

OCC is required to perform on-site assessments of the corrective actions taken by the bank. If a bank has failed to adopt policies, procedures, and systems within required timeframes set forth in a commitment letter, there is a strong presumption that more severe action is necessary.

In June 2004, OCC met with the National Family Bank's Board of Directors to determine what progress the Board had made with respect to the commitment letter. At that time, the Board informed OCC that the Complainant was planning to sell the bank and that the strategic direction of the bank would be more focused on the sale of the bank. As a result, the approach the Board was taking to address weaknesses in the commitment letter changed. The Board stated that it would continue to address concerns but would not purchase the new information technology system that it had planned to purchase. OCC informed the Board that plans to sell the bank did not change the need for adequate control systems to monitor and control risk within the bank.

In September 2004, OCC conducted an on-site visit to follow up on management efforts to address the weaknesses specified in the commitment letter. As a result of that visit, OCC informed the Board on November 2, 2004, that the bank was not in compliance with any of the articles of the commitment letter and asked the Board to provide a written response detailing the actions taken to address the weaknesses. OCC warned the Board that failure to address the weaknesses could result in increased supervisory actions, including a formal agreement. OCC also informed the

[14] The commitment letter also contained provisions addressing the need for the bank to improve internal controls, develop an internal audit function, improve its information technology function, complete a Bank Secrecy Act audit, and implement a staffing plan.

Board that if significant violations occurred due to lack of training or lack of effective audit and compliance functions, civil money penalties could be assessed.

In November 2004, OCC was informed that several members of the bank's management had resigned. The President of the bank resigned his position as President and member of the Board of Directors due to the deterioration of his relationship with the Complainant. This action left the Board of Directors with only four members. OCC notified the bank on December 9, 2004 that it was in violation of 12 U.S.C. § 71a, the federal statute that establishes the minimum number of directors required for a national bank's Board of Directors. Section 71a requires a national bank to have a board consisting of not fewer than 5 members. The bank's cashier had also resigned.

OCC required the Board to provide a written plan detailing the immediate actions that it was taking to come into compliance with the statutory requirement that the Board have at least five members. Because the bank was now without a president and cashier, OCC reminded the Board that one of the Board's fundamental responsibilities was to retain competent management to manage the bank's day-to-day functions. OCC informed the Board it was required to provide a written plan detailing the actions it would take to obtain a fifth board member and to fill the vacant cashier's position. The written plans were to be provided to OCC by December 13, 2004. On December 10, 2004, the Complainant informed OCC that a sale agreement had been signed and that the bank was being sold. In addition, the Complainant responded to OCC's requests for a written plan detailing the actions the Board was taking to fill the vacant positions and obtain a fifth Board member.

Although supervisory actions taken by OCC may be construed as placing pressure on a bank's management and Board, they represent the normal progression of OCC's supervisory strategy and are discussed in OCC publications that national bank directors have a responsibility to read.[15]

Based on our review of OCC's supervisory documentation, we found that OCC adhered to its policies and procedures related to informal enforcement actions, such as (1) entering into a commitment letter with a financial institution, (2) conducting follow-up meetings and on-site visits to monitor management progress on the commitment letter, (3) and taking actions where the bank has failed to address corrective actions within the agreed timeframes.

We found that OCC's enforcement actions were not undue and that OCC followed its policies and procedures in applying pressure on National Family Bank to effect necessary improvements in the internal controls of the bank as agreed to in the April 2004 commitment letter. Consequently, we found this allegation to be without merit.

[15] These OCC publications include the *OCC Handbook Community Bank Supervision*; *Detecting Red Flags in Board Reports, A Guide for Directors;* and *Internal Controls, A Guide for Directors* and are available at OCC's Web site. The Red Flag and Internal Controls handbooks were given to each member of the National Family Bank Board of Directors at the December 12, 2001, Board meeting because OCC was contemplating lowering the bank's composite CAMELS rating from 2 to 3.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Alain Dubois
Director, Banking Audits
Department of the Treasury Office of Inspector General

From: John C. Dugan
Comptroller of the Currency

Date: September 20, 2006

Subject: Comments on Draft Audit Report

We have received and reviewed your draft report titled "OCC: Allegations Regarding the Supervision of National Family Bank." Your objectives were to determine whether the OCC conducted its supervisory activities of National Family Bank in accordance with OCC policies and procedures and whether there was merit to allegations you received from the former majority owner and Chairman of the Board of the bank.

We are pleased that you found that the allegations were without merit.

You also found, though, that the OCC had not adhered to its policy to obtain and keep a receipt from the management of the bank acknowledging their review of the 2003 report of examination. As noted in your report, we were unable to locate the receipt during the course of your audit. Staff has been reminded of the importance of obtaining and filing receipts.

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

Name of Department, Office, Agency

Alain Dubois, Director, Banking Audits
Valerie A. Freeman, Audit Manager
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Department of the Treasury

Office of Strategic Planning and Performance Management
Office of Accounting and Internal Control

Comptroller of the Currency

Comptroller of the Currency
Liaison Officer

Office of Management and Budget

OIG Budget Examiner