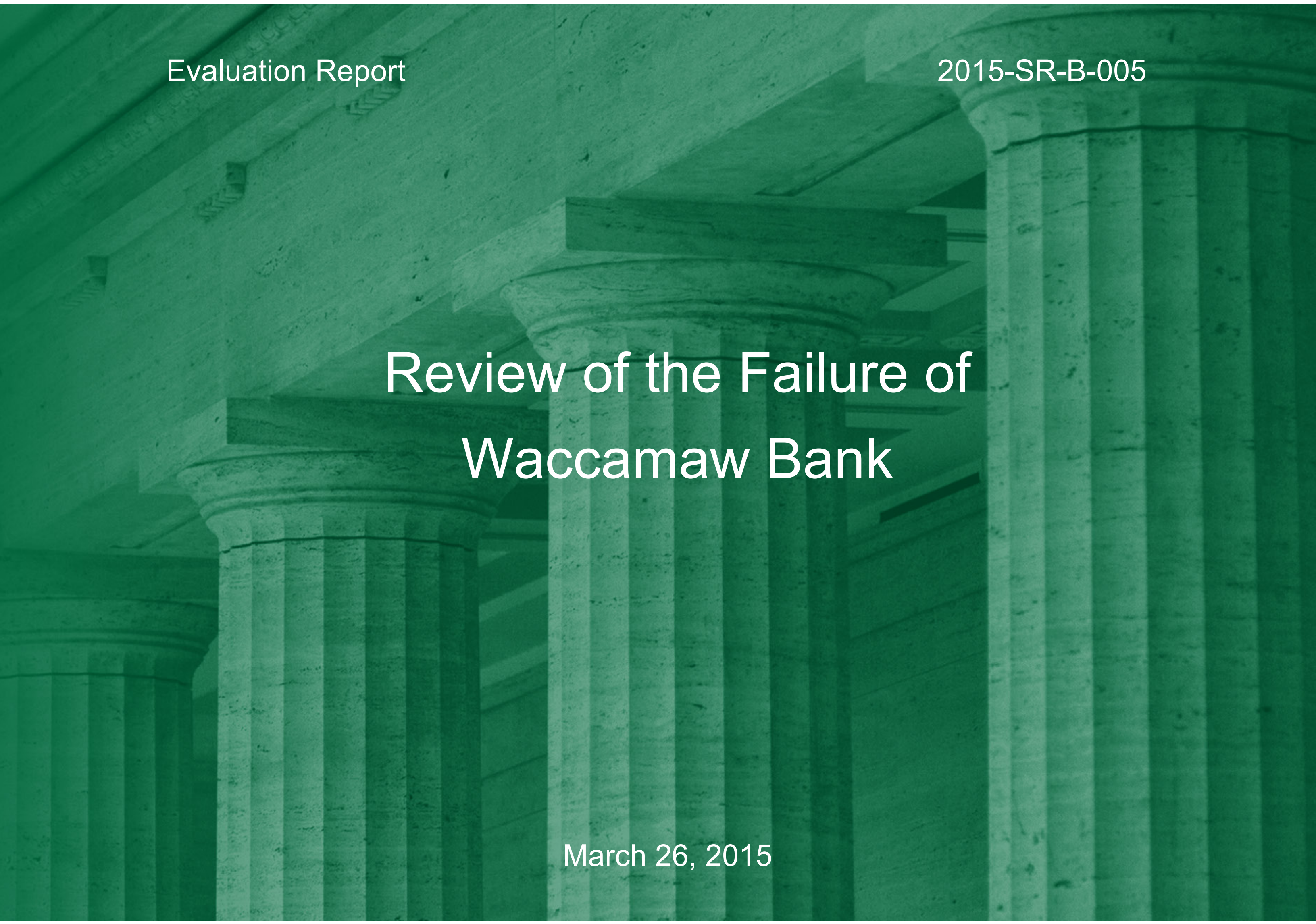
Office of Inspector General



Evaluation Report 2015-SR-B-005

Review of the Failure of Waccamaw Bank

March 26, 2015

Board of Governors of the Federal Reserve System

Consumer Financial Protection Bureau

Report Contributors

Shannon Williams, OIG Manager
Saurav Prasad, Project Lead (December 2012–June 2014)
Michael Olukoya, Project Lead (June 2014–present)
Michael VanHuysen, Senior OIG Manager for Supervision and Regulation
Melissa Heist, Associate Inspector General for Audits and Evaluations

Abbreviations

ADC	acquisition, development, and construction
Board	Board of Governors of the Federal Reserve System
CBEM	*Commercial Bank Examination Manual*
CRE	commercial real estate
DIF	Deposit Insurance Fund
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
FDIC	Federal Deposit Insurance Corporation
FRB Atlanta	Federal Reserve Bank of Atlanta
FRB Philadelphia	Federal Reserve Bank of Philadelphia
FRB Richmond	Federal Reserve Bank of Richmond
HELOC	home equity line of credit
IT	Information Technology
PCA	prompt corrective action
Reserve Bank	Federal Reserve Bank
SR Letter 07-1	Supervision and Regulation Letter 07-1, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*
State	North Carolina Office of the Commissioner of Banks
Waccamaw	Waccamaw Bank

Executive Summary:

Review of the Failure of Waccamaw Bank

2015-SR-B-005 **March 26, 2015**

Purpose

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Office of Inspector General conducted an in-depth review of the failure of Waccamaw Bank (Waccamaw) because the failure presented unusual circumstances that warranted an in-depth review.

Background

Waccamaw, headquartered in Whiteville, North Carolina, opened on September 2, 1997, and became a state member bank on May 31, 2001. The bank was supervised by the Federal Reserve Bank of Richmond (FRB Richmond), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the North Carolina Office of the Commissioner of Banks (State). On June 8, 2012, the State closed Waccamaw and appointed the Federal Deposit Insurance Corporation as receiver.

Findings

Waccamaw failed because its board of directors and senior management did not control the risks associated with its rapid growth strategy. This strategy consisted of expanding the bank's branch network and growing its commercial real estate lending portfolio, particularly the acquisition, development, and construction segment of the commercial real estate portfolio. As a result of this strategy, Waccamaw developed high commercial real estate and acquisition, development, and construction loan concentrations. Meanwhile, the bank's branch network expansion increased overhead expenses and decreased the bank's profitability. This combination heightened Waccamaw's vulnerability to weak economic conditions. Following a decline in the local economy, the bank's commercial real estate loans experienced substantial losses, which began to erode capital.

In assessing a transaction designed to augment the bank's capital, FRB Richmond made a material supervisory determination that prohibited the bank from considering the proceeds resulting from a sale of preferred stock as regulatory capital. Waccamaw filed a series of appeals contesting this determination, which ultimately proceeded to the Board for consideration. In January 2012, a Board Governor reversed the results of the prior appeals and allowed Waccamaw to consider some of the proceeds from the preferred stock sale as regulatory capital. Nevertheless, Waccamaw's persistent asset quality deterioration continued its losses, which further depleted capital and resulted in the bank becoming *critically undercapitalized* in April 2012. The State appointed the Federal Deposit Insurance Corporation as receiver and closed the bank on June 8, 2012.

With respect to supervision, FRB Richmond complied with the applicable examination frequency guidelines for the time frame we reviewed, conducted regular offsite monitoring, and implemented applicable prompt corrective action provisions. Our review noted three issues that this failure had in common with other failures, which are outlined in our *Summary Analysis of Failed Bank Reviews* report. In addition, we have specific findings involving unique supervisory aspects associated with this failure.

Recommendations

We made recommendations to address supervisory aspects associated with the failure of Waccamaw. In his response to our draft report, the Director of the Division of Banking Supervision and Regulation agreed with our recommendations and outlined planned corrective actions to address them.

Summary of Recommendations, OIG Report No. 2015-SR-B-005

Rec. no.	Report page no.	Recommendation	Responsible office
1	16	Ensure that the Federal Reserve Bank of Richmond preserves departing examination staff members' supervisory records in accordance with the *Board Records Retention and Disposition Schedule*.	Division of Banking Supervision and Regulation
2	16	Reinforce with each Federal Reserve Bank the importance of preserving departing examination staff members' supervisory records in accordance with applicable Board and Federal Reserve Bank policies.	Division of Banking Supervision and Regulation
3	18	Require that the Federal Reserve Banks include a standard provision as part of future formal enforcement actions with institutions in troubled financial condition specifying the need for formal approval of material transactions.	Division of Banking Supervision and Regulation
4	19	Review and update the Board's *Guidelines for Appeals of Material Supervisory Determinations* to establish a framework for Federal Reserve Bank Presidents and the Board to conduct appeals. In addition to any enhancements identified during the review, the framework should address a. the standard of review for the appeal. b. whether the appellant has the burden of proof to demonstrate that the material supervisory determination should be reversed. c. whether the party assessing the higher-level appeal is limited to reviewing the prior factual record. d. whether the appellant has the right to comment on the evidence providing the basis for the initial material supervisory determination, even if confidential supervisory information protections apply.	Division of Banking Supervision and Regulation
5	22	Ensure that the Board updates its appeals policy to prohibit supervisory team members from coordinating any aspect of the appeal process.	Division of Banking Supervision and Regulation

OFFICE OF INSPECTOR GENERAL

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

CONSUMER FINANCIAL PROTECTION BUREAU

March 26, 2015

MEMORANDUM

TO: Michael S. Gibson
Director, Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System

FROM: Melissa Heist Melissa Heist
Associate Inspector General for Audits and Evaluations

SUBJECT: OIG Report No. 2015-SR-B-005: *Review of the Failure of Waccamaw Bank*

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. 1831o(k), the Office of Inspector General conducted an in-depth review of the failure of Waccamaw Bank. This report reflects the results of our review.

We provided the Division of Banking Supervision and Regulation with a draft of our report for review and comment. In your response, you indicated that your staff generally agreed with the conclusions and recommendations in our report. We have included your response as appendix C in our report.

We appreciate the cooperation that we received from staff of the Federal Reserve Bank of Richmond, the Federal Reserve Bank of Atlanta, and the Board of Governors of the Federal Reserve System during our review. This report will be added to our public website and will be summarized in our next *Semiannual Report to Congress*. Please contact me if you would like to discuss this report or any related issues.

cc: Jennifer Burns
Michael Johnson
Jack Jennings
Kevin Bertsch
Rick Watkins
William Mitchell
J. Anthony Ogden

Contents

Introduction

Background

Waccamaw Bank (Waccamaw), headquartered in Whiteville, North Carolina, opened on September 2, 1997. The bank became a state member bank on May 31, 2001, and formed Waccamaw Bankshares, Inc.,[1] a publicly traded one-bank holding company on June 30, 2001. By 2008, Waccamaw's branch network had expanded to 17 locations in North Carolina's Columbus, Brunswick, and Bladen Counties and South Carolina's Lancaster and Horry Counties. The bank was supervised by the Federal Reserve Bank of Richmond (FRB Richmond), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the North Carolina Office of the Commissioner of Banks (State).

The State closed Waccamaw on June 8, 2012, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. According to the FDIC, as of March 31, 2012, Waccamaw had approximately $533.1 million in total assets. In addition, the FDIC estimated that the failure would result in a $51.1 million loss to the Deposit Insurance Fund (DIF). At the time, section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), defined a material loss to the DIF as an estimated loss in excess of $150 million.[2] The estimated loss to the DIF associated with the failure of Waccamaw did not meet the threshold for materiality. For failures beneath the material loss threshold, the Dodd-Frank Act requires our office to assess whether the circumstances surrounding the failure were unusual. Upon identifying unusual circumstances warranting additional review, our office conducts an in-depth review similar to a material loss review. We determined that Waccamaw's failure presented unusual circumstances that warranted an in-depth review.[3]

Objectives, Scope, Methodology, and Scope Limitation

When a loss to the DIF presents unusual circumstances, section 38(k) of the Federal Deposit Insurance Act requires that the Inspector General of the appropriate federal banking agency prepare a report in a manner that is consistent with the requirements of a material loss review. The material loss review provisions of section 38(k) require that the Inspector General of the appropriate federal banking agency undertake the following:

- review the agency's supervision of the failed institution, including the agency's implementation of prompt corrective action (PCA)
- ascertain why the institution's problems resulted in a material loss to the DIF
- make recommendations for preventing any such loss in the future

1. Waccamaw's shares were publicly traded on the NASDAQ stock exchange.

2. The $150 million materiality threshold applied to losses that occurred from January 1, 2012, through December 31, 2013.

3. This review fulfills a statutory mandate and does not serve any investigative purposes.

Our review covered supervisory activity from 2007 through 2012. To accomplish our objectives, we reviewed the Federal Reserve System's *Commercial Bank Examination Manual* (CBEM) and relevant supervisory guidance. We interviewed staff and collected relevant data from FRB Richmond, the Federal Reserve Bank of Atlanta (FRB Atlanta), the State, and the Board. We also reviewed correspondence, surveillance reports, regulatory reports filed by Waccamaw, examination reports, examination workpapers prepared by FRB Richmond and FRB Atlanta, relevant FDIC documents, and reports prepared by multiple accounting firms.

In addition, we reviewed the January 2010 to June 2012 e-mail communications of certain FRB Richmond staff members to develop a better understanding of Waccamaw's discussions with the Federal Reserve Bank (Reserve Bank) concerning a capital-raise transaction. FRB Richmond did not retain the e-mail records for two supervisors who served in leadership roles for FRB Richmond's supervisory team at Waccamaw during key time periods. We attempted to gain access to some of these e-mail records by requesting Waccamaw's records from the FDIC as of the date of its failure. We obtained the bank's records directly from the FDIC's Division of Resolutions and Receiverships, and we appreciate the FDIC's cooperation in responding to our request. We considered FRB Richmond's inability to produce all the requested records in response to our request a scope limitation for our evaluation.[4]

We conducted this evaluation from December 2012 through November 2014 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency. Appendixes at the end of this report include a glossary of key banking and regulatory terms and a description of the CAMELS rating system.[5]

4. A scope limitation arises when we are not able to complete our evaluation as comprehensively as intended.

5. The CAMELS acronym represents six components: ***c***apital adequacy, ***a***sset quality, ***m***anagement practices, ***e***arnings performance, ***l***iquidity position, and ***s***ensitivity to market risk. For full-scope examinations, examiners assign a rating of 1 through 5 for each component and the overall composite score, with 1 indicating the least regulatory concern and 5 indicating the greatest concern.

Causes of the Failure

Waccamaw failed because its board of directors and senior management did not control the risks associated with its rapid growth strategy. This strategy consisted of expanding the bank's branch network and growing its commercial real estate (CRE) lending portfolio, particularly the acquisition, development, and construction (ADC) segment of the CRE portfolio. As a result of this strategy, Waccamaw developed high CRE and ADC loan concentrations. Meanwhile, the bank's branch network expansion increased overhead expenses and decreased the bank's profitability. This combination heightened Waccamaw's vulnerability to weak economic conditions. Following a decline in the bank's local economy, the CRE loans in its portfolio experienced substantial losses, which began to erode capital.

In an effort to raise capital, Waccamaw entered into an asset swap transaction. A component of this transaction involved the bank selling its noncumulative perpetual preferred stock for $16.3 million.[6] FRB Richmond made a material supervisory determination that prohibited Waccamaw from considering the $16.3 million in proceeds resulting from the sale as regulatory capital because FRB Richmond considered the asset swap transaction to be a circular transaction in which the bank funded the sale of its own capital.[7] In response to this material supervisory determination, Waccamaw filed a series of appeals that ultimately proceeded to the Board for consideration. In January 2012, a Board Governor reversed the results of the prior appeals and allowed Waccamaw to consider $8.4 million of the proceeds from the preferred stock sale as regulatory capital. Nevertheless, Waccamaw's persistent asset quality deterioration continued its losses, which further depleted capital and resulted in the bank becoming *critically undercapitalized* in April 2012. The State appointed the FDIC as receiver and closed the bank on June 8, 2012.

Management Pursued an Aggressive Growth Strategy

From 1999 through 2011, Waccamaw's total assets increased from $38 million to $566 million and the number of branch locations increased from 3 to 17. The bank's total asset growth was primarily due to its CRE lending activities, as management sought to capitalize on the burgeoning real estate development market in North Carolina's coastal areas. In its 2007 five-year strategic plan, Waccamaw's management noted its intent to (1) continue to grow to $1 billion in total assets by 2013 and (2) increase the number of branches to more than 20 by 2012. FRB Richmond examiners warned management that this expansion strategy would impact Waccamaw's capital, earnings, and liquidity. During the same examination, FRB Richmond examiners noted that

6. Noncumulative perpetual preferred stock allows the issuer to waive payment of dividends. Dividends do not accumulate to future periods nor do they represent a contingent claim on the issuer.

7. Title 12, *Code of Federal Regulations*, part 225, appendix A, section II(i), states that to qualify as an element of tier 1 or tier 2 capital, an instrument must be fully paid up and effectively unsecured. Accordingly, if a banking organization has purchased, or has directly or indirectly funded the purchase of, its own capital instrument, that instrument generally is disqualified from inclusion in regulatory capital.

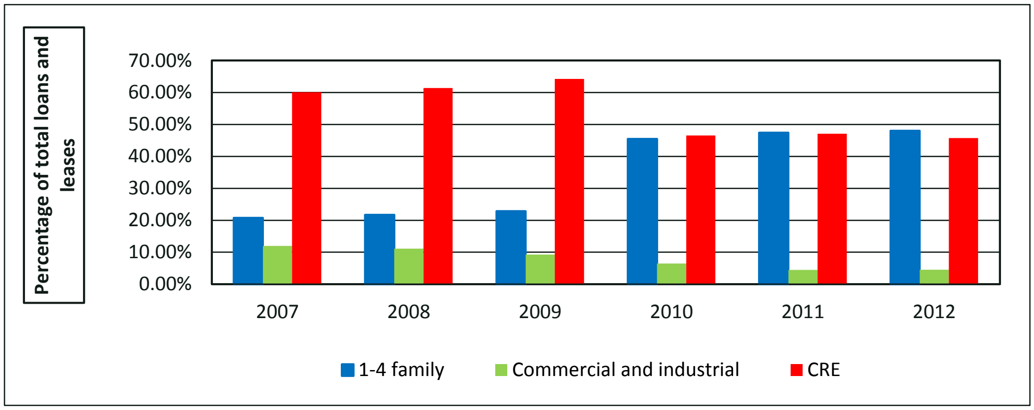
Waccamaw’s back-office infrastructure was “overburdened” even before management began to pursue its branch network expansion objectives outlined in the five-year plan.

CRE and ADC Concentrations Increased Exposure to Declining Economy

Since its inception, Waccamaw’s core business activities included CRE lending. To increase the size of its loan portfolio, Waccamaw pursued a rapid growth strategy that focused on CRE lending. Initially, the bank funded its CRE lending growth by using core deposits. Beginning in 2007, management transitioned to brokered deposits as a funding source to accelerate growth. We noted that from 2002 through 2009, Waccamaw’s reliance on brokered deposits as a funding source increased from $7 million to $125 million. According to the CBEM, brokered deposits can weaken a bank by allowing it to grow too quickly. Additionally, reliance on noncore funding is risky because such funding may not be available in times of financial stress or adverse changes in market conditions.

From 2002 through 2008, Waccamaw’s CRE loan portfolio grew 650 percent, from $31.6 million to $237 million. Further, ADC loans, a component of the CRE portfolio, increased 431 percent, from $23.7 million to $125.9 million. As illustrated in figure 1, CRE loans were more than 50 percent of the bank’s loan portfolio until 2009. Waccamaw’s rapid loan growth led to high CRE and ADC loan concentrations. These loan concentrations heightened Waccamaw’s exposure to downturns in its local markets.

Figure 1: Waccamaw’s Loan Types as Percentage of Total Loans and Leases, 2007–March 2012



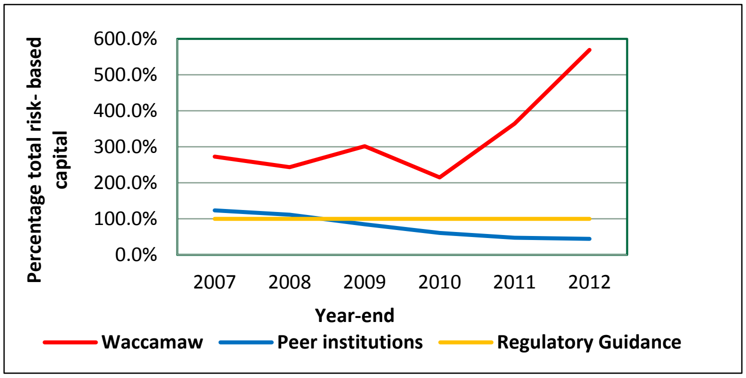
Source: Waccamaw’s Call Reports, December 2007 through March 2012.

Notes: Data for 2007–2011 are year-end; data for 2012 are through March. The label *1–4 family* refers to loans secured by single-family properties. Some of these loans include single-family home mortgages and home equity lines of credit.

Figure 2 illustrates Waccamaw’s ADC concentration from December 2007 to March 2012. The bank’s ADC concentration was more than twice the threshold outlined in the Board’s Supervision and Regulation Letter 07-1, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (SR Letter 07-1), for an institution presenting a potentially significant

ADC concentration risk.[8] Conversely, from 2007 to 2012, Waccamaw's peer institutions decreased their ADC concentration levels from 123.6 percent of total risk-based capital to 44.2 percent. ADC concentrations generally present heightened risk because a developer's capacity to repay a loan depends on whether the developer can obtain long-term financing or find a buyer for the completed project.

Figure 2: ADC Concentrations, 2007–March 2012

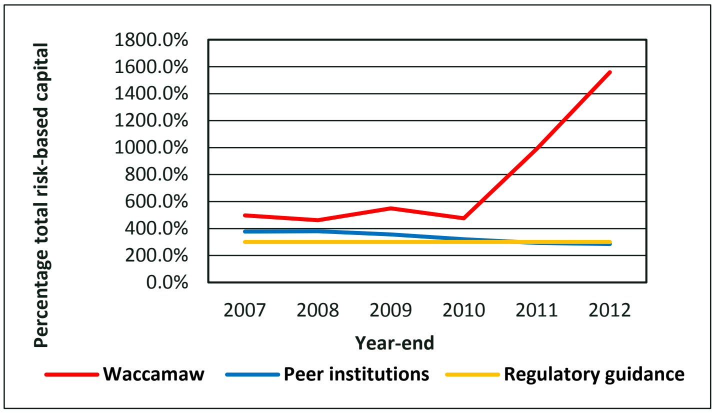


Source: Waccamaw's *Uniform Bank Performance Report*s, December 2007 through March 2012.

Note: Data for 2007–2011 are year-end; data for 2012 are through March.

Figure 3 illustrates Waccamaw's CRE concentration as a percentage of total risk-based capital from December 2007 to March 2012. During this time period, the bank also exceeded (1) the threshold in SR Letter 07-1 for an institution presenting a potentially significant CRE concentration risk and (2) its peer institutions' CRE concentration levels. As highlighted in our September 2011 *Summary Analysis of Failed Bank Reviews*, asset concentrations tied to CRE loans increase a bank's vulnerability to changes in the marketplace and compound the risks inherent in individual loans.

Figure 3: CRE Concentrations, 2007–March 2012



Source: Waccamaw's *Uniform Bank Performance Reports*, December 2007 through March 2012.

Note: Data for 2007–2011 are year-end; data for 2012 are through March.

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8. According to SR Letter 07-1, an institution presents a potentially significant CRE concentration risk if total reported construction, land, and development loans represent 100 percent or more of its total capital.

Branch Expansion Affected Profitability

In 2007, management began implementing its growth strategy by expanding its branch network, even though FRB Richmond examiners expressed concerns regarding management's decision to open additional branches. The bank opened 6 branches in 2007. As part of Waccamaw's 2007 five-year strategic plan, the bank anticipated opening 2 or 3 branches every year until it had a total of 25 branches. Waccamaw's total assets and deposits increased after the new branches became operational. From 2007 through 2008, Waccamaw's total assets increased 6 percent, or by $29.3 million. In addition, the bank's core deposits increased 11.6 percent while brokered deposits increased 439.7 percent.

From December 2007 through December 2008, the bank's noninterest expense increased 51 percent, from $12.3 million to $18.5 million. In 2009, State examiners reported that Waccamaw's overhead expenses had increased by $4.8 million due to the addition of new branches. During the same examination, State examiners noted that the six branches opened in 2007 had yet to be profitable. Further, Waccamaw's net interest margin,[9] an indicator of the bank's profitability, became strained due to its declining interest income and high cost of funds associated with the use of brokered deposits. During 2007 and 2008, Waccamaw's net interest margin declined by 114 basis points, while its peer institutions' net interest margin declined by 24 basis points.[10]

Corporate Governance Weaknesses and Management Failures Led to Enforcement Actions

Waccamaw's management implemented an aggressive growth strategy that relied on CRE lending funded by brokered deposits. However, management failed to implement adequate risk management practices and effective controls to monitor the bank's increasing risk, particularly in its CRE portfolio. Specifically, Waccamaw's management failed to implement examiner recommendations designed to improve the bank's credit risk management. During a February 2009 examination, examiners recommended that the bank (1) maintain a loan review system that could assist with managing risk in the loan portfolio, (2) ensure that loan reviews include appropriate documentation, and (3) enhance reporting on loan portfolio stratification. These recommendations were recurring findings highlighted during previous examinations. As a result of management's inability to adequately address these recommendations, FRB Richmond implemented successive enforcement actions, including a board resolution in July 2009 and a written agreement in June 2010.

Among other things, the board resolution compelled management to perform a comprehensive review of credit administration, loan review, and risk grading. The written agreement, among other things, required management to submit a capital plan and perform a management assessment. In addition, the enforcement action prohibited the bank from (1) declaring or paying

9. *Net interest margin* is a performance metric used to evaluate a bank's profitability by measuring the difference between interest income generated in comparison to the interest paid.

10. A basis point is one hundredth of a percentage point.

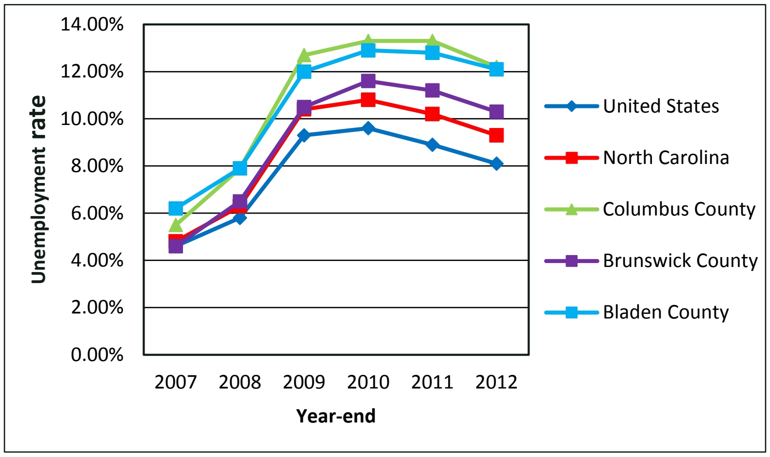
any dividends without prior regulatory approval or (2) accepting or renewing any brokered deposits.

The results of the management assessment performed by a third party revealed that Waccamaw's board emphasized profitability and growth over strong risk management. In addition, the management assessment report noted that management did not adapt to declines in the local real estate market. Further, the report mentioned a disagreement between board members concerning the need to raise capital. According to the report, the bank's former Chairman and a specific board member sought to prevent any shareholder dilution and concerns about shareholder dilution took precedence over the bank's deteriorating condition. One board member resigned because of the disagreement concerning the need to raise capital. The report recommended that Waccamaw add a skilled Chief Financial Officer, remove three board members, and supplement the board's knowledge by using consultants.

Decline in Local Economy and Asset Quality Deterioration Resulted in Losses

Beginning in 2007, examiners identified a decline in Waccamaw's local economy, particularly in the local real estate market. From 2007 through 2011, the bank's delinquent ADC loans increased from $85,000 to $10.2 million. Examiners advised management to strengthen its use of economic data so that it could adapt to changing local market conditions. Figures 4 and 5 illustrate the growing unemployment rate in the bank's local markets. Those markets experienced higher unemployment rates than the respective states and the national averages. Waccamaw could not adapt to these declines because of its high concentration levels and limited options for raising deposits.

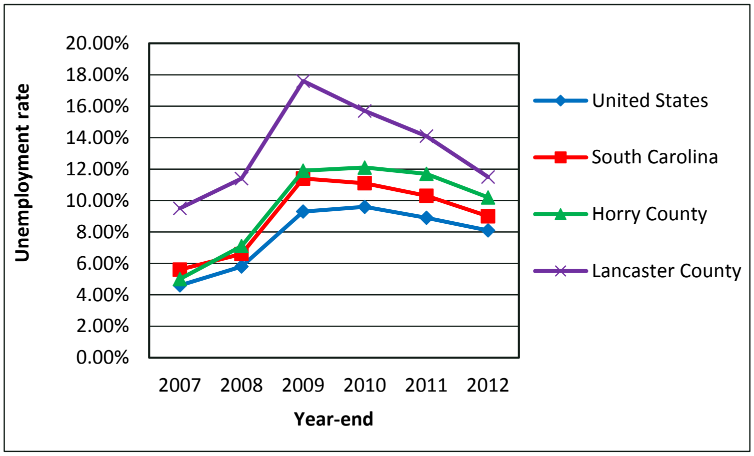
Figure 4: North Carolina Unemployment, 2007–2012



Source: FDIC Regional Economics Condition website.

Note: Columbus, Brunswick, and Bladen Counties are those in which Waccamaw had branch locations.

Figure 5: South Carolina Unemployment, 2007–2012



Source: FDIC Regional Economics Condition website.

Note: Horry and Lancaster Counties are those in which Waccamaw had branch locations.

As the bank's local economy declined, noncurrent and nonaccrual loans increased. From 2007 through 2012, Waccamaw's total nonaccrual loans increased from $4 million to $41 million. In 2009, examiners reported that a majority of the nonaccrual loans were ADC loans. Further, from 2007 through March 2012, Waccamaw's foreclosure losses and other-real-estate-owned losses increased from $0 to $14.7 million and from $318,000 to $9.7 million, respectively.

Deficient Allowance for Loan and Lease Losses Level and Methodology Limited Management's Ability to Forecast Losses

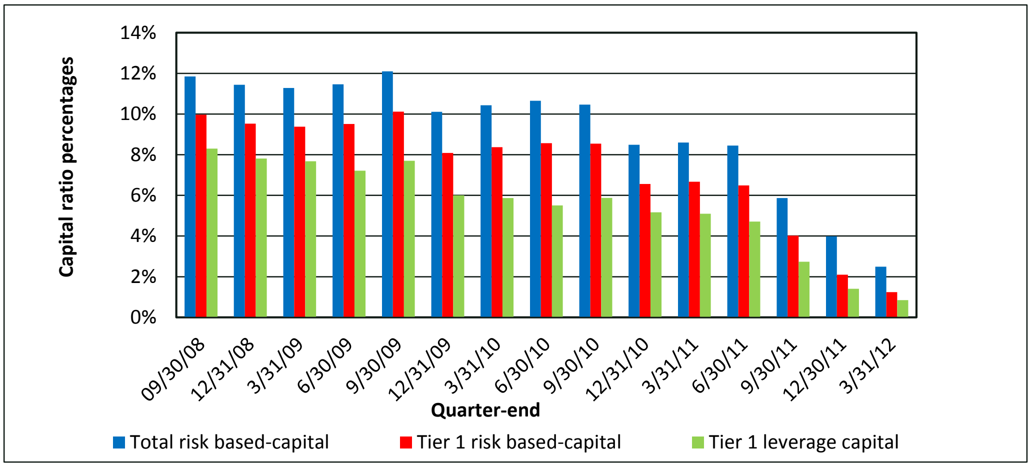
Examiners repeatedly criticized Waccamaw's allowance for loan and lease losses methodology. For instance, in 2010, FRB Richmond examiners highlighted the divergence between the bank's allowance for loan and lease losses methodology and current accounting or regulatory practices. During the March 2011 State examination, examiners noted that the bank's methodology did not incorporate an analysis of the $110 million home equity line of credit (HELOC) portfolio the bank purchased in December 2010.

Because the bank's management lacked the tools to adequately manage its CRE portfolio, Waccamaw could not effectively forecast the reserves needed to offset anticipated loan and lease losses. Therefore, as loan losses increased, the bank's provision expenses increased to address the deficiencies in the allowance for loan and lease losses, which further strained profitability.

Capital Erosion and Effort to Raise Capital Led to Acquisition of HELOC Portfolio

Figure 6 illustrates that Waccamaw remained *well capitalized* until December 2010.[11] Nevertheless, examiners noted as early as August 2009 that current capital levels could not support the bank's risk profile. Asset quality deterioration in the CRE portfolio and provision expenses impacted earnings. Waccamaw took provision expenses of $2.9 million in 2008 and $16.6 million in 2009. Increasing provision expenses eliminated earnings and began to erode the bank's capital. As a result, the 2010 written agreement required management to recapitalize the bank. Waccamaw submitted the first of several capital plans in October 2010.

Figure 6: Waccamaw's Quarterly Capital Ratios, September 30, 2008–March 31, 2012



Source: Waccamaw's Quarterly *Uniform Bank Performance Reports*, September 2008 through March 2012.

Asset Swap Transaction Failed to Improve the Bank's Condition

In August 2010, Waccamaw's management met with FRB Richmond and State examiners to discuss alternatives for raising capital. Management outlined several options, including (1) the sale and leaseback of assets and (2) an asset swap involving nonperforming assets for first mortgage loans or HELOCs. On December 22, 2010, Waccamaw completed an asset swap transaction in which the bank purchased a $110 million HELOC portfolio for $99.3 million cash and $11.2 million in nonperforming asset loans. The following day, the bank completed another transaction in which it received $16.3 million from the sale of its noncumulative perpetual preferred stock.

FRB Richmond examiners highlighted several concerns about the asset swap transaction: (1) the price of the HELOC portfolio, (2) the relationship between parties in the transaction and the source of the funds used to complete the $16.3 million preferred stock purchase, and (3) the effectiveness of the credit enhancement provided by the seller of the HELOC portfolio.

11. Although Waccamaw was *well capitalized* as of December 2010, an FRB Richmond July 2011 directive required the bank to refile its December 2010 and March 2011 Call Reports. The refilings accelerated the decline in the bank's PCA status from *well capitalized* in December 2010 to *undercapitalized* as of March 2011.

Due, in part, to the asset swap transaction occurring the day before the preferred stock sale, FRB Richmond examiners suspected that proceeds associated with the asset swap transaction funded the preferred stock purchase. In an e-mail to bank management, an FRB Richmond official reported that Waccamaw wired the funds for the HELOC portfolio on December 22, 2010, and the bank received $16.3 million for payment of its preferred stock on December 23, 2010. The same FRB Richmond official noted that the counterparties in the asset swap transaction and the preferred stock purchase had not provided certified financial statements. This omission increased FRB Richmond's suspicions that the preferred stock sale could not have occurred without the asset swap transaction. Based on these findings, FRB Richmond prohibited Waccamaw from considering the $16.3 million as regulatory capital in June 2011. As a result, Waccamaw filed a series of appeals—to FRB Richmond's appeals panel on September 8, 2011; to the President of FRB Richmond on November 1, 2011; and to the Board on December 20, 2011.

The material supervisory determination prohibiting Waccamaw from considering the proceeds associated with the preferred stock sale as regulatory capital required Waccamaw to refile its March 2011 Call Report. The revised filing lowered the bank's PCA status from *well capitalized* to *undercapitalized*.[12] Due to an ongoing decline to its capital resulting from continued CRE loan losses, examiners asked Waccamaw to submit a capital restoration plan by August 2011. Waccamaw submitted two capital restoration plans, in September 2011 and in October 2011. Examiners rejected both plans due to a lack of firm commitments from investors and management's unrealistic and inaccurate assumptions supporting the accompanying financial projections. Waccamaw became *critically undercapitalized* in September 2011.

Because of the continued capital erosion, FRB Richmond issued a PCA notice in December 2011. The PCA notice directed management to restore the bank to *adequately capitalized* status by January 2012. The Board's appeal decision permitted the bank to consider $8.4 million of the $16.3 million from the sale of the preferred stock as regulatory capital, Waccamaw's PCA status improved to *significantly undercapitalized* as of January 2012. However, continued asset quality deterioration in the bank's loan portfolio and the resulting losses caused Waccamaw to become *critically undercapitalized* as of April 9, 2012.[13] As a result, the State appointed the FDIC as receiver.

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12. Per the CBEM, PCA uses the total risk-based capital, tier 1 risk-based capital, and tangible equity ratio for assigning state member banks to one of the five capital categories (*well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*). A bank is considered *undercapitalized* if the total risk-based ratio is less than 8 percent, the tier 1 risk-based capital and leverage ratio is less than 4 percent, or the leverage ratio is less than 3 percent and the bank received a CAMELS composite rating of 1 in its most recent examination and is not experiencing or anticipating any growth.

13. Once a bank becomes *critically undercapitalized* under PCA standards, the bank has a 90-day window to improve its condition; otherwise, it is closed by the applicable chartering authority with the concurrence of the FDIC.

Supervision of Waccamaw

FRB Richmond complied with the examination frequency guidelines contained in CBEM section 1000.1 for the time frame we reviewed, 2007 through 2012, and conducted regular offsite monitoring. During this time period, FRB Richmond and the State conducted four full-scope examinations, five target examinations, and one visitation related to an asset swap transaction. Supervisory activity during the time frame under review resulted in three enforcement actions: a board resolution, a written agreement, and a PCA directive. FRB Richmond also implemented applicable PCA provisions. As shown in table 1, Waccamaw's CAMELS composite rating declined from 2 to 5 in less than three years.

Table 1: Waccamaw Supervisory Overview

Examination					CAMELS component and risk management ratings							Supervisory actions
Start date	Report issue date	Scope	Agency conducting examination	CAMELS composite rating	Capital	Asset quality	Management	Earnings	Liquidity	Sensitivity	Risk management	
09/24/2007	11/16/2007	Full	FRB Richmond	2	2	2	2	2	2	2	2	
02/02/2009	06/05/2009	Full	State	3	3	4	3	3	3	3	3	Board resolution adopted 07/16/2009
08/31/2009	02/04/2010	Target	FRB Richmond	4	4	4	3	5	3	3	3	Troubled condition designation[a]
01/25/2010	07/30/2010	Full	FRB Richmond (joint)	5	5	5	5	5	5	4	5	Written agreement effective 06/14/2010
09/27/2010	01/28/2011	Target	FRB Richmond	5	5	5	5	5	5	4	5	
01/19/2011	05/02/2011	Visitation	FRB Richmond	-	-	-	-	-	-	-	-	
03/14/2011	07/05/2011	Full	State (joint)	5	5	5	5	5	4	4	5	
06/27/2011	07/19/2011	Target	FRB Richmond	5	5	5	5	5	4	4	5	
10/17/2011	01/06/2012	Target	FRB Richmond	5	5	5	5	5	5	5	5	PCA directive issued 12/02/2011
02/06/2012	04/24/2012	Target	FRB Atlanta[b] (joint)	5	5	5	5	5	5	5	5	

Source: Waccamaw examination reports, 2007 through 2012.

[a]A state member bank is in troubled financial condition, if it (1) has a composite rating at its last examination of 4 or 5; (2) is subject to a cease and desist order or formal written agreement that requires improvement to the financial condition of the institution; or (3) is expressly informed by the Board or the Reserve Bank that it is in troubled condition.

[b]At the time of this examination, Waccamaw's appeal related to FRB Richmond's decision to disallow the $16 million in preferred stock, as regulatory capital was still ongoing. As a result, FRB Atlanta performed this examination to avoid any conflict of interest.

While this rapid CAMELS composite rating decline is somewhat unique compared with our prior failed bank reviews, we noted the following instances where issues outlined in our *Summary Analysis of Failed Bank Reviews* were similar to Waccamaw's supervisory history:

- **Different approaches to aggressive growth strategies:** Like the FRB Richmond supervisory team for Waccamaw, many Reserve Bank examination teams questioned the advisability of aggressive growth strategies but did not take aggressive action. By contrast, certain supervisory teams requested that specific institutions refrain from additional growth.

- **Limitations of PCA assessments:** We noted instances in which specific state member banks remained *well capitalized* under PCA guidelines, even though the applicable examination team noted that the banks' capital position did not support its risk profile prior to its PCA status declines.

- **Financial performance declines as a prerequisite for aggressive supervisory action:** In many instances, we noted that examiners detected many of the risks that eventually contributed to the failure, but refrained from taking aggressive supervisory action until the bank experienced declines in financial performance. As part of this theme, we highlighted the need for a forward-looking examination approach that involves clear and forceful communications during stable economic periods.

We address these common supervisory issues below, and the subsequent discussion in our findings and recommendations focuses on the unique supervisory aspects associated with this particular failure. This Supervision of Waccamaw section follows a topic-based approach rather than providing a detailed description of the facts and circumstances associated with each examination conducted during the five years preceding the failure. In terms of the unique supervisory history associated with this failure, our findings and recommendations focus on (1) the need to preserve Reserve Bank supervisory records, (2) the circumstances surrounding Waccamaw management's vetting of an asset swap transaction with FRB Richmond, (3) the appeals process for material supervisory determinations, and (4) examination report content that provides an inaccurate account of actual supervisory history.

Supervisory Approach to Aggressive Growth Strategy

In its 2007 five-year strategic plan, Waccamaw noted management's intent to expand the bank's branch network and grow total assets to $1 billion by 2013. During a September 2007 FRB Richmond full-scope examination, examiners reported that management planned to open six new branches in 2007. In response to management's aggressive growth plans, examiners encouraged management to proactively implement the bank's branching strategy by balancing growth with improvements to controls and risk management practices. Further, examiners warned that (1) earnings retention alone would not support management's plan for branch expansion and (2) branch network expansion would place pressure on the bank's earnings. During the same examination, FRB Richmond examiners highlighted declines in the bank's local real estate market. Despite the warnings from examiners concerning management's growth plans and signs of initial declines in the local real estate market, management continued to grow its CRE and ADC portfolio well into 2008.

FRB Richmond responded to management's questionable business strategy in a manner similar to the supervisory approach that we noted in many prior state member bank failures. In those failures, examiners apprised management of the risks associated with the relevant strategy and questioned the advisability of that strategy but refrained from taking more aggressive action. By contrast, Reserve Bank examiners in certain other failures responded to questionable business strategies by taking a more aggressive approach that included requesting that management refrain from additional growth. Because we have previously addressed the need for stronger supervisory action sooner in our prior failed bank reviews and in our *Summary Analysis of Failed Bank Reviews*, we do not have any additional recommendations related to FRB Richmond's supervisory approach to responding to management's five-year plan in 2007.

Limitations of PCA Assessments

As early as August 2009, State examiners noted that the bank's capital levels were not commensurate with its risk profile, even though Waccamaw remained *well capitalized* for PCA purposes. The bank remained *well capitalized* under PCA guidelines until December 2010. Sixteen months later, it became *critically undercapitalized*.

As noted in our *Summary Analysis of Failed Bank Reviews*, certain state member banks that failed remained *well capitalized* under PCA guidelines, even though the applicable examination team noted that the relevant institution's capital position did not support the bank's risk profile. This contrast highlights how significantly PCA quantitative assessments can lag examiners' more subjective assessment of capital in relation to a bank's risk profile. In addition, our report noted that PCA designations may directly contradict an examination team's actual assessment of a bank's capital position and thereby send mixed messages to the board of directors and management. Because we previously issued a matter for consideration designed to address enhancements to the PCA framework, we have no further recommendations related to this issue.

Declines in Financial Performance as a Prerequisite to Aggressive Supervisory Action

As noted in our *Summary Analysis of Failed Bank Reviews*, many failed banks received at least one double or triple downgrade of a CAMELS composite or component rating prior to the eventual failure. Our report noted that these downgrades highlighted supervisory weaknesses because even when examiners noted material issues and risks that could lead to the failure of a bank, examiners did not take aggressive supervisory action until the bank's financial performance declined.

During a September 2007 FRB Richmond examination, examiners identified weaknesses in the bank's credit administration and high CRE and ADC concentrations. Examiners noted that the bank's CRE and ADC concentrations were 484 percent and 279 percent of total risk-based capital, respectively. In addition, examiners noted that both ratios exceeded the bank's peer group CRE and ADC concentration levels. Further, examiners advised management to adhere to sound risk management practices for CRE concentrations outlined in recently published CRE guidance—an apparent reference to SR Letter 07-1. Examiners also warned that the bank's expansion plans would strain earnings performance, liquidity, and capital adequacy. In addition to the deficiencies identified during this examination, examiners noted declines in the bank's local real estate market. Despite the weaknesses identified during this review, the bank received a *satisfactory* rating. The subsequent examination resulted in a double downgrade to the asset quality CAMELS component rating and a board resolution.

During that examination, State examiners noted that the bank's financial condition had deteriorated significantly, as Waccamaw experienced severe loan losses in its CRE portfolio. As a result, the State downgraded the bank's CAMELS composite rating from 2 to 3 and double downgraded the asset quality component rating to 4. Ongoing losses prompted examiners to further downgrade the bank's CAMELS composite rating to 5 during a July 2010 joint examination report. Within 13 months, Waccamaw's CAMELS composite rating declined from 3 to 5.

Similar to state member bank failures noted in our *Summary Analysis of Failed Bank Reviews*, FRB Richmond examiners had the opportunity for stronger supervisory action, such as CAMELS composite or component ratings downgrades, as early as the 2007 full-scope examination. Many of the weaknesses and risks identified during the 2007 examination remained unresolved and ultimately contributed to the bank's failure. Because we have previously noted the need for a forward-looking examination approach that does not rely on declines in financial performance to take aggressive supervisory action, we have no additional recommendations related to the similar facts and circumstances we noted during this review.

Finding 1: E-mails Containing Supervisory Activity Records Were Not Maintained in Accordance With Board Policy

FRB Richmond did not retain the e-mails of two retired FRB Richmond officials responsible for supervising the Reserve Bank's supervisory team at Waccamaw from 2008 through April 2011. Supervision is a delegated function performed by the Reserve Banks on behalf of the Board. In this instance, we confirmed that FRB Richmond does not have its own policies governing records retention, and it follows the Board's *Records Retention and Disposition Schedule*. This schedule requires supervisory records, including e-mails, to be retained for five years. However, interviewees from FRB Richmond Information Technology (IT) indicated that the Reserve Bank retains e-mails of former employees for two months.[14] The absence of these records created a scope limitation for our evaluation, which impaired our ability to fully assess the circumstances surrounding the vetting of the capital-raise transaction.

FRB Richmond IT Did Not Retain Supervisory Records of FRB Richmond Officials

As part of our review, we requested the e-mails of certain FRB Richmond officials. To obtain the e-mails, we met with FRB Richmond IT and the Federal Reserve Bank of Philadelphia (FRB Philadelphia) Groupware Leadership Center. FRB Richmond IT provides for and supports the technological needs of all FRB Richmond staff, and the FRB Philadelphia Groupware Leadership Center coordinates and oversees the planning, implementation, and functional enhancement of the Federal Reserve System's enterprise collaboration and messaging services and provides central support services.

During our review period, FRB Richmond followed the *Board Records Retention and Disposition Schedule*, which requires that supervisory records, including e-mails, be retained for five years. After the five-year retention period, records can be destroyed when no longer needed for administrative purposes. Our review of FRB Richmond e-mails revealed that FRB Richmond IT did not retain, for the required period of time, the e-mails for two retired senior FRB Richmond officials who supervised Waccamaw from 2008 through April 2011.

An FRB Richmond IT supervisor stated that FRB Richmond's standard practice is to retain e-mails for two months following an employee's departure, unless directed otherwise by senior management. As a separate process, the FRB Philadelphia Groupware Leadership Center also retains e-mails for approximately two weeks after an employee leaves a Reserve Bank. FRB Richmond's practice of purging the e-mails of senior officials directly involved in supervising state member banks did not comply with the Board's records retention schedule. Both officials supervised the examination team at Waccamaw and served as points of contact for Waccamaw management. Our inability to access these records created a scope limitation for our evaluation, which impacted our ability to fully assess the events surrounding the vetting of the capital-raise transaction.

14. In this instance, both of the FRB Richmond officials had been retired for more than two months.

Management Actions Taken

In February 2013, the Board and several Reserve Banks performed a self-assessment to evaluate the management of Board records for supervision and regulation activities. The objectives of the assessment included (1) creating a standard methodology for Reserve Banks to evaluate their supervision and regulation records management program and (2) informing the Federal Reserve System about supervision and regulation records management by documenting the results. FRB Richmond participated in the records management self-assessment, assessing its compliance with the Board's records retention policy and its internal processes, policies, and procedures for records management. FRB Richmond's assessment noted several opportunities for improvements, which included developing new policies, implementing a new document management system, establishing organizational accountabilities for records management responsibilities, and increasing staff education and training. We intend to conduct future follow-up activities to assess the extent to which the actions described in this section are responsive to the concerns raised in this finding.

Recommendations

We recommend that the Director of the Division of Banking Supervision and Regulation

1. Ensure that FRB Richmond preserves departing examination staff members' supervisory records in accordance with the *Board Records Retention and Disposition Schedule*.

2. Reinforce with each Reserve Bank the importance of preserving departing examination staff members' supervisory records in accordance with applicable Board and Reserve Bank policies.

Management's Response

The Director of the Division of Banking Supervision and Regulation agreed with our recommendations. In his response to recommendations 1 and 2, the Director stated that Banking Supervision and Regulation staff concurred that supervisory records must be retained in accordance with the *Board Records Retention and Disposition Schedule* and will continue to reinforce with Reserve Banks the importance of preserving departing examination staff members' supervisory records in accordance with Board policy. Banking Supervision and Regulation staff intend to work with other Board staff to ensure compliance with Board policy and to assess the extent to which the actions taken are responsive to our findings.

OIG Comment

The actions described by the Director of Banking Supervision and Regulation appear to be responsive to our recommendations. We plan to follow up on the Board's actions to ensure that the recommendations are fully addressed.

Finding 2: The Written Agreement Did Not Contain a Provision Requiring the Prior Approval of Material Transactions

FRB Richmond's formal enforcement action with Waccamaw, the written agreement in June 2010, did not explicitly require FRB Richmond to approve any material transactions. We did not identify any supervisory guidance that specifically requires a formal enforcement action to contain such a provision; nevertheless, we believe that such an approach would be a prudent practice that would eliminate the uncertainty we encountered on this point during our review. In this instance, interviewees were unsure whether the written agreement required Waccamaw to obtain prior formal approval for material transactions. This uncertainty appeared to contribute to FRB Richmond's passive approach to reviewing the proposed capital-raise transaction.

FRB Richmond Officials Were Uncertain as to Whether the Written Agreement Required Regulatory Approval of Material Transactions

As a result of its failure to comply with a previously issued board resolution and the continued deterioration in the bank's financial condition, Waccamaw entered into a written agreement with FRB Richmond and the State on June 14, 2010. The written agreement directed management to develop a capital plan, perform a management assessment, avoid issuing or renewing brokered deposits, and strengthen credit risk management practices. Interviewees expressed uncertainty about whether the written agreement required prior approval for major transactions, such as the $110 million asset swap transaction completed in December 2010. We compared Waccamaw's written agreement to other formal enforcement actions issued by FRB Richmond and noted little variation between those actions. FRB Richmond appeared to use a standard format, similar language, and reporting requirements for each of the enforcement actions we reviewed.

Despite this apparent uncertainty, an interviewee noted that section 16(a) of Waccamaw's written agreement required the bank to submit a strategic plan and budget for the remainder of 2010. The strategic plan provision contained in the written agreement required the bank to address, among other things, (1) areas in which the board would seek to improve the bank's operating performance; (2) operating assumptions that supported projected income, expenses, and balance sheet components; and (3) a realistic and comprehensive budget for 2010 that included income statement and balance sheet projections. We determined that Waccamaw's strategic plan submitted on November 10, 2010, did not describe the asset swap transaction.

In September 2010, Waccamaw submitted a letter to FRB Richmond requesting approval of the asset swap transaction. The letter described the components of the transaction at a conceptual level: (1) Waccamaw will acquire selected HELOCs and will receive a credit enhancement associated with the HELOCs, (2) Waccamaw will sell selected nonperforming assets, (3) Waccamaw will supplement the balance of the transaction with cash, and (4) the seller of the HELOC portfolio will purchase $3 million of Waccamaw's noncumulative perpetual preferred stock.

Rather than seek additional details about the transaction or direct Waccamaw to include the transaction in its strategic plan, FRB Richmond officials issued a response in which the Reserve

Bank approved the debt component of the transaction and stated, "We are not opining on the other transactions around the issuance of th[is] subordinated debt." We believe that this passive approach represented a missed opportunity by FRB Richmond to obtain the additional information it needed to approve or reject the transaction or to require Waccamaw to include the transaction in the strategic plan.

Recommendation

We recommend that the Director of the Division of Banking Supervision and Regulation

3. Require that the Reserve Banks include a standard provision as part of future formal enforcement actions with institutions in troubled financial condition specifying the need for formal approval of material transactions.

Management's Response

The Director of the Division of Banking Supervision and Regulation agreed with our recommendation. In his response to recommendation 3, the Director stated that Banking Supervision and Regulation staff will develop a standard provision, to include as part of future formal enforcement actions with institutions in troubled financial condition, that specifies the need for formal approval of material transactions.

OIG Comment

The actions described by the Director of Banking Supervision and Regulation appear to be responsive to our recommendation. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

Finding 3: Controlling Policies Did Not Address Certain Procedural Aspects Associated With the Appeals Process

Our review of the Board's *Guidelines for Appeals of Material Supervisory Determinations* and FRB Richmond's *Policy Statement on Appeals of Material Supervisory Determination* revealed that both policies discuss standards and procedures Reserve Banks should follow when reviewing appeals of material supervisory determinations. In addition, both policies address the composition and appointment of the appeals panel and the appeals review process, including the evaluation of evidence and applicable time frames for resolution of appeals. Further, both policies outline the process for filing a subsequent appeal to the Reserve Bank President and the Board of Governors. Nevertheless, neither policy outlines a standard procedural framework for conducting a subsequent appeal. For example, both policies remain silent on key procedural aspects of the second- and third-level appeal, including (1) the standard for the review; (2) the allocation of the burden of proof; (3) the scope of the record to be reviewed and whether additional evidence may be gathered; and (4) the appellant's right to review and rebut the evidence that resulted in the material supervisory determination, even if confidential supervisory information protections apply. In our opinion, these illustrative omissions may lead to variations in the approach to the procedural aspects of an appeal.

Recommendation

We recommend that the Director of the Division of Banking Supervision and Regulation

4. Review and update the Board's *Guidelines for Appeals of Material Supervisory Determinations* to establish a framework for Reserve Bank Presidents and the Board to conduct appeals. In addition to any enhancements identified during the review, the framework should address

    a. the standard of review for the appeal.

    b. whether the appellant has the burden of proof to demonstrate that the material supervisory determination should be reversed.

    c. whether the party assessing the higher-level appeal is limited to reviewing the prior factual record.

    d. whether the appellant has the right to comment on the evidence providing the basis for the initial material supervisory determination, even if confidential supervisory information protections apply.

Management's Response

The Director of the Division of Banking Supervision and Regulation agreed with our recommendation. In his response to recommendation 4, the Director stated that Banking

Supervision and Regulation staff agree that the Board's *Guidelines for Appeals of Material Supervisory Determinations* should be updated to address the elements listed in the OIG's draft report. The Director noted that Banking Supervision and Regulation staff are developing revised guidance that will address the OIG's recommended changes and are making other enhancements to this process.

OIG Comment

The actions described by the Director of Banking Supervision and Regulation appear to be responsive to our recommendation. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

Finding 4: The Appearance of a Conflict of Interest Existed Concerning the Selection of the Appeals Panel

A senior FRB Richmond official involved in issuing the material supervisory determination under appeal by Waccamaw initiated the request to organize the appeals panel. FRB Richmond's appeals policy, including updates to the policy, addresses conflicts of interest related to examiners participating in appeals panels for institutions they supervised. However, the policy does not address the possible appearance of a conflict of interest that we observed in this situation. In our opinion, this official's involvement in the material supervisory determination under appeal and any aspect of the appeals panel, including initiating the request to convene the panel, created an appearance of a conflict of interest. In our opinion, any appearance of a conflict of interest can undermine the integrity of the process.

FRB Richmond's Appeals Panel Was Organized by an FRB Richmond Official Responsible for the Matter Under Appeal

On September 8, 2011, Waccamaw appealed FRB Richmond's material supervisory determination that $16.3 million in proceeds from the sale of preferred stock could not be counted as regulatory capital.[15] A senior FRB Richmond official involved in supervising Waccamaw and responsible for the material supervisory determination under appeal initiated the request to convene the appeals panel. Although this official did not participate in the appeals panel, we believe that this official's prior involvement in the matter under appeal presented the appearance of a conflict of interest.[16] We do not believe, however, that this appearance issue affected the outcome of the appeal.

Our review of FRB Richmond's appeals policy in effect at the time, as well as an updated version issued in August 2012, confirmed that the policies prohibit examiners from participating on appeals panels for banks they supervised. However, neither iteration completely separates the team members involved in supervising the institution initiating the appeal from all aspects of the appeals process. In our opinion, any appearance of a conflict of interest can undermine the integrity of the process.

15. Waccamaw filed an initial appeal to FRB Richmond's appeals panel on September 8, 2011; to the FRB Richmond President on November 1, 2011; and to the Board on December 20, 2012.

16. As previously discussed, this retired official's e-mails were not retained by FRB Richmond and were unavailable for review.

Recommendation

We recommend that the Director of the Division of Banking Supervision and Regulation

5. Ensure that the Board updates its appeals policy to prohibit supervisory team members from coordinating any aspect of the appeal process.

Management's Response

The Director of the Division of Banking Supervision and Regulation agreed with our recommendation. In his response to recommendation 5, the Director stated that Banking Supervision and Regulation staff agree that the Board's *Guidelines for Appeals of Material Supervisory Determinations* should be updated to address the elements listed in the OIG's draft report and noted that Banking Supervision and Regulation staff are developing revised guidance that will address the OIG's recommended changes and are making other enhancements to this process.

OIG Comment

The actions described by the Director of Banking Supervision and Regulation appear to be responsive to our recommendation. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

Finding 5: Examination Reports Contained Inaccurate Information About a Material Transaction

During our review, we found that two consecutive examination reports—a January 2011 target examination report issued by FRB Richmond and a July 2011 joint examination report issued by the State—contained inaccurate information related to an asset swap transaction completed in December 2010. FRB Richmond conducted the January 2011 target examination and participated in the latter joint examination. FRB Richmond examiners attributed the factual inaccuracies contained in both reports to oversights during the report review process and acknowledged that the correct information should have been included. Inaccurate information in examination reports presents reputation risk to the relevant Reserve Bank and may impact work products that rely on such information.

FRB Richmond Did Not Include Key Details About the Asset Swap Transaction in the January 2011 and July 2011 Examination Reports

During our review, we found two consecutive examination reports that inaccurately described the circumstances and supervisory activities surrounding the asset swap transaction completed by Waccamaw in December 2010. The first examination report, issued on January 28, 2011, detailed the results of the FRB Richmond's September 2010 examination. A brief discussion of the transaction in that report incorrectly stated that the asset swap transaction totaled $56 million rather than the actual amount of the transaction, which was $110 million. FRB Richmond became aware of the full details of the asset swap transaction and subsequent capital infusion at a January 19, 2011, meeting with Waccamaw management.[17]

The second examination report, issued on July 5, 2011, detailed the results of a March 2011 examination. In this instance, the State led the joint examination; State examiners drafted the report, and FRB Richmond examiners reviewed the report prior to its issuance. This report accurately described the terms of the deal but inaccurately stated that Waccamaw had failed to request regulatory approval to perform the asset swap transaction. As part of our review, we concluded that Waccamaw management requested approval for the transaction on September 24, 2010, in a letter addressed to the State and FRB Richmond describing the transaction at a conceptual level. Specifically, Waccamaw requested approval for the issuance of $3 million in subordinated debt and other aspects of the asset swap transaction.

Interviews with certain FRB Richmond senior officials responsible for supervising Waccamaw prior to its failure led us to believe that Waccamaw completed the capital-raise transaction without seeking prior approval from FRB Richmond. However, during an interview with another FRB Richmond examiner, we learned that FRB Richmond issued a response to Waccamaw's September 2010 request letter describing the transaction on September 29, 2010. A review of this letter indicated that FRB Richmond officials approved the debt issuance but explicitly stated that

17. The meeting was an onsite review of the asset swap transaction Waccamaw completed in December 2010. The examination was originally scheduled for December 2010 but was postponed to January 2011 in response to a request from Waccamaw's Chief Executive Officer.

"we are not opining on the other transactions around the issuance of th[is] subordinated debt" as discussed in the September 24, 2010, letter.

The subsequent October 2011 examination report issued by FRB Richmond accurately noted the details of the transaction. However, it did not mention the September 29, 2010, letter sent by FRB Richmond. An FRB Richmond official who supervised Waccamaw told us that the information surrounding the requested approval should have been included in the prior reports. Another FRB Richmond examiner verified that the January 2011 and July 2011 examination reports included inaccurate statements and noted that their inclusion was an oversight. This examiner also noted that he did not see the July 2011 report but acknowledged that FRB Richmond had an opportunity to review the State's report for the joint examination. When issuing a joint report, FRB Richmond should ensure the accuracy of the information contained in the report. Inaccurate information contained in an examination report can affect assessments performed by other regulators and presents reputation risk to the Reserve Bank.

Management Actions Taken

As part of its response to a prior finding and recommendation associated with our *Material Loss Review of the Bank of the Commonwealth*, FRB Richmond recently completed a Six Sigma review designed to enhance the effectiveness of its report review process.[18] While we recently closed out the recommendation associated with the prior review, we emphasize that factual accuracy should be an important aspect of the updated report review process. According to FRB Richmond, some of the improvements to its review process include holding meetings with all examiners and FRB Richmond officials who supervise a bank to ensure that the information in an examination report is accurate prior to its issuance and taking into account ongoing deliberations held outside the examination process. In addition, FRB Richmond noted that the updated process includes performing a quality control check on numerical data listed in examination reports. FRB Richmond described its three-step report review process conducted by the lead examiner and senior FRB Richmond officials prior to issuance. Because of the corrective actions outlined above, we are not making any additional recommendations regarding this finding.

18. Six Sigma is a process improvement methodology that consists of a set of statistical methods used for systematically analyzing processes to reduce variation.

Appendix A
Glossary of Banking and Regulatory Terms

Acquisition, Development, and Construction (ADC) Loans

ADC loans are a component of commercial real estate loans that provide funding for acquiring and developing land for future construction and interim financing for residential or commercial structures.

Allowance for Loan and Lease Losses

A valuation reserve established and maintained by charges against the bank's operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. The reserve must be sufficient to absorb probable losses inherent in the institution's loan and lease portfolio.

Call Reports

*Report*s *of Condition and Income* are commonly known as Call Reports. Every state member bank is required to file a consolidated Call Report normally as of the close of business on the last calendar day of each calendar quarter, i.e., the report date.

Classified Assets

Loans that exhibit well-defined weaknesses and a distinct possibility of loss. Classified assets are divided into more specific subcategories ranging from least to most severe: *substandard*, *doubtful*, and *loss*. An asset classified as *substandard* is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. An asset classified as *doubtful* has all the weaknesses inherent in one classified as *substandard*, with the added characteristic that the weaknesses make full collection or liquidation highly questionable and improbable. An asset classified as *loss* is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted.

Commercial Real Estate (CRE) Loans

Land development and construction loans (including one- to four-family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm, nonresidential property where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

Concentration

A significant amount of direct or indirect extensions of credit and contingent obligations that possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations.

Enforcement Actions

The Board has a broad range of enforcement powers that include formal or informal enforcement actions that may be taken, typically after the completion of an onsite bank examination. Formal enforcement actions consist of written agreements, temporary cease-and-desist orders, cease-and-desist orders, prohibition and removal orders, and PCA directives; informal enforcement actions include commitment letters, board resolutions, and memorandums of understanding.

Liquidity

The ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or converting assets, promptly and at a reasonable cost.

Nonaccrual

Nonaccrual status means loans with overdue interest payments and uncertainty regarding collection of principal; no interest income is recognized on these loans for reporting purposes.

Noncore Funding

Funding that can be very sensitive to changes in interest rates, such as brokered deposits, certificates of deposit greater than $100,000, federal funds purchased, and borrowed money.

Other Real Estate Owned

Real estate acquired by a lender through foreclosure in satisfaction of a debt. A loan secured by foreclosed real estate is counted as a nonperforming loan in reporting loan quality in Call Reports to bank supervisory agencies.

Prompt Corrective Action (PCA)

A framework of supervisory actions, set forth in title 12, section 1831o, of the *United States Code*, for insured depository institutions whose capital positions have declined below certain threshold levels. It was intended to ensure that when an institution becomes financially troubled, action is taken to resolve the problems of the institution and incur the least possible long-term loss to the DIF. The capital categories are *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*.

Supervision and Regulation Letters

Supervision and Regulation Letters are issued by the Board's Division of Banking Supervision and Regulation. They address significant policy and procedural matters of continuing relevance to the Board's supervisory effort. Supervision and Regulation Letters are for distribution to supervised institutions as well as Reserve Banks.

Tier 1 Capital

The sum of core capital elements (common equity, including capital stock, surplus, and undivided profits; qualifying noncumulative perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries) less any amounts of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted, and unrealized holding losses in the available-for-sale equity portfolio, as well as any investments in subsidiaries that the Federal Reserve determines should be deducted from tier 1 capital. Tier 1 capital elements represent the highest form of capital, namely, permanent equity.

Underwriting

Detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower, such as employment history, salary, and financial statements; publicly available information, such as the borrower's credit history; and the lender's evaluation of the borrower's credit needs and ability to pay.

Written Agreement

A formal supervisory enforcement action that is generally issued when a financial or an institution-affiliated party has multiple deficiencies that are serious enough to warrant formal action or that have not been corrected under an informal action. It is an agreement between a financial institution and the Board or a Reserve Bank that may require the financial institution or the institution-affiliated party to (1) stop engaging in specific practices or violations or (2) take action to correct any resulting conditions. The agreement may also require the financial institution to provide ongoing information, such as progress reports. This enforcement action is the least severe of the formal enforcement actions.

Appendix B
CAMELS Rating System

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of the institution's financial condition and operations:

adequacy of ***c***_apital_
quality of ***a***_ssets_
capability of ***m***_anagement_
quality and level of ***e***_arnings_
adequacy of ***l***_iquidity_
s_ensitivity_ to market risk

Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1-to-5 numerical scale. The highest rating, 1, indicates the strongest performance and risk management practices and the least degree of supervisory concern, while 5 indicates the weakest performance, inadequate risk management practices, and the highest degree of supervisory concern.

Composite Rating Definitions

The five composite ratings are defined and distinguished below. Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance.

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences, such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to their size, complexity, and risk profile and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For financial institutions to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institutions' size, complexity, and risk profile. As there are no material supervisory concerns, the supervisory response is informal and limited.

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institutions' size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The board of directors and management are not satisfactorily addressing or resolving weaknesses and problems. Financial institutions in this group generally are not capable of withstanding business fluctuations and may be significantly noncompliant with laws and regulations. Risk management practices are generally unacceptable relative to the institutions' size, complexity, and risk profile. Close supervisory attention is required; in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the DIF. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institutions' size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed for these financial institutions to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the DIF, and failure is highly probable.

Appendix C
Management's Response

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: March 10, 2015

To: Melissa Heist, Associate Inspector General

From: Michael S. Gibson, Director, Division of Banking Supervision and Regulation MSG

Subject: Review of the Failure of Waccamaw Bank

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Review of the Failure of Bank of Waccamaw Bank, (Waccamaw), Whiteville, North Carolina, prepared by the Office of Inspector General (OIG). The report finds that Waccamaw failed, among other reasons, because of inadequate controls over risk management associated with rapid growth, as well as a buildup of concentrations of credit that were subsequently negatively impacted by declining economic conditions. Waccamaw was supervised by the Federal Reserve Bank of Richmond (FRB Richmond) under delegated authority from the Board.

The report notes that FRB Richmond complied with the applicable Federal Reserve examination frequency guidelines. However, the report makes recommendations to address some unique issues that were found in the OIG's review of Waccamaw's supervision.

Banking Supervision and Regulation (BS&R) staff acknowledge the conclusions in the report. Waccamaw's failure illustrates the risks associated with aggressive growth and high concentrations of credit and the importance of establishing appropriate risk management practices. It further illustrates the need for stronger supervisory action where significant and unresolved weaknesses exist.

Regarding the recommendations made in the OIG's report, BS&R staff agree that supervisory records must be retained in accordance with the *Board Records Retention and Disposition Schedule* (Records Schedule) and will continue to reinforce with Reserve Banks the importance of preserving departing examination staff members' supervisory records in accordance with Board policy. Some of the work in response to these recommendations has already been completed. In 2013, each of the twelve Reserve Banks participated in a self-assessment to evaluate its management of Board records for supervision and regulation activities (self-assessment program). The objectives of the self-assessment program included (1) creating a standard methodology for Reserve Banks to evaluate their supervision and regulation records management program and (2) documenting the results.

FRB Richmond staff participated in the self-assessment program in February 2013. As a result, FRB Richmond staff noted several opportunities for improvements, which included developing new policies, implementing a new document management system, establishing organizational accountabilities for records management responsibilities, and increasing staff education and training. The Records Schedule requires retention of supervisory records; therefore, emails of staff that are determined to be supervisory records should be retained in accordance with the Records Schedule requirements. BS&R staff intend to work with other Board staff to ensure compliance with Board policy and to assess the extent to which the actions taken are responsive to the OIG's finding.

Moreover, BS&R staff will develop a standard provision to include as part of future formal enforcement actions with institutions in troubled financial condition specifying the need for formal approval of material transactions.

Lastly, BS&R staff agree that the Board's *Guidelines for Appeals of Material Supervisory Determinations* should be updated to address the elements listed in the OIG's draft report. Staff are developing revised guidance that will address the OIG's recommended changes as well as make other enhancements to this process.

Office of Inspector General

Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

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