

Board of Governors of the Federal Reserve System

**Audit of the Board's Processing of Applications
for the Capital Purchase Program under
the Troubled Asset Relief Program**



Office of Inspector General

September 2009



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

September 30, 2009

Ms. Norah Barger, Acting Director
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Ms. Barger:

The Office of Inspector General (OIG) of the Board of Governors of the Federal Reserve System (Board) is pleased to present its report on the *Audit of the Board's Processing of Applications for the Capital Purchase Program under the Troubled Asset Relief Program*. The Troubled Asset Relief Program (TARP) Capital Purchase Program (CPP) authorizes the U.S. Department of the Treasury (Treasury) to fund qualified financial institutions with up to \$250 billion of capital through the purchase of preferred shares or senior securities of the qualifying institutions. To participate in the CPP, a qualified and interested financial institution submits an application to its primary federal regulator: the Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, or the Office of Thrift Supervision. Each federal banking regulator is responsible for reviewing CPP applications from the institutions it supervises and for making recommendations to Treasury on whether the applications should be approved or denied. A CPP recommendation is to be based on an assessment of the overall viability of the institution (excluding potential CPP funds). Treasury makes the final approval decision on eligibility and the allocation of funds.

In addition to obtaining an overview of the Board's CPP implementation, our audit objective was to assess the Board's process and controls for reviewing CPP applications from Board-supervised financial institutions seeking to participate in the CPP. To accomplish our objective, we analyzed guidance provided by Treasury and procedures developed by the Board, assessed and compiled summary information on Board-supervised institutions that applied for CPP funds, interviewed Board and Federal Reserve Bank staff, and tested a sample of applications processed by the Board to determine compliance with Treasury and Board procedures. We also reviewed confidential examination reports and other supervisory data for these financial institutions.

As of July 2009, the Board had received 325 applications from financial institutions requesting \$42.9 billion in CPP funds. The Board recommended 128 of these applications to Treasury for approval. Of these 128 applications, Treasury approved 123 (107 were funded for \$29.1 billion and 16 were pending funding), and had 5 applications in process.

Overall, we found that the Board's limited internal procedures were consistent with Treasury's guidance for reviewing applications and making recommendations for funding. In addition, we found that the Board forwarded recommendations for approval to Treasury that generally reflected compliance with Treasury's guidance and the Board's internal procedures.

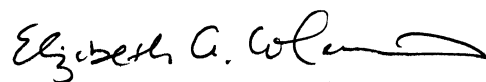
Our testing identified some compliance deficiencies, such as incomplete documentation on analysis of the institutions' capital, asset quality, earnings, and liquidity; missing quality assurance certifications by Reserve Bank senior officials; and a lack of documentation on analysis of institutions' ongoing viability. However, due to compensating controls at the Board, we did not identify any instances where these deficiencies led to approval of financial institutions that did not meet eligibility criteria or that otherwise should not have been approved. We found that the Board received limited guidance from Treasury in the early stages of the CPP program regarding what analysis should be performed to determine the viability of the financial institutions. As the Board began reviewing applications under the limited guidance, Board officials raised issues to Treasury officials that resulted in additional Treasury guidance, and the Board sent email messages to the Reserve Banks outlining procedures for processing the applications and additional analysis to be performed in reviewing the applications. Although not required by Treasury, we believe that formal, detailed and documented procedures would have provided the Board and the Reserve Banks additional assurance of consistently and completely analyzing CPP applications. As the CPP application phase draws down and the Board's efforts become more focused on reviewing the CPP-funded institutions' requests to repay the funds (called redemptions), we are recommending that the Board ensure that a complete, formal, and documented set of procedures is in place to guide the analysis of redemption requests.

We also found that, while the Board has established tracking systems to document outside contacts regarding the CPP program and the Board's responses, CPP-related communications between Reserve Bank staffs and institutions have not been documented and tracked. While we did not identify any improper communications, going forward we are recommending that a system be developed to track relevant communications between Reserve Bank staffs and institutions regarding CPP and redemption requests.

We provided our draft report to you for review and comment. Your response is included as Appendix 1. In your response, you indicated that you concur with the review findings and will take steps to address the report recommendations.

We appreciate the cooperation that we received from Board and Reserve Bank staff during our review. The principal OIG contributors to this report are listed in Appendix 2. We are providing copies of this report to Board management officials. The report will be added to our public website and will be summarized in our next semiannual report to the Congress. Please contact me if you would like to discuss the report or any related issues.

Sincerely,



Elizabeth A. Coleman
Inspector General

cc: Governor Daniel K. Tarullo
Governor Elizabeth A. Duke
Mr. Kevin M. Bertsch
Ms. Cynthia L. Course

Board of Governors of the Federal Reserve System

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Background

In October 2008, the Emergency Economic Stabilization Act of 2008 (EESA) established the Office of Financial Stability within the U.S. Department of the Treasury (Treasury) and authorized the Troubled Asset Relief Program (TARP). Under the TARP's Capital Purchase Program (CPP), Treasury is authorized to provide up to \$250 billion in capital to qualified financial institutions. The CPP is a voluntary program in which the U.S. Government, through the Treasury, invests in qualified financial institutions through purchases of preferred stock or senior securities issued by the institutions. The CPP is available to qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies engaged solely or predominately in financial activities.

In October 2008, Treasury issued limited guidance to assist federal banking regulators in reviewing CPP applications. Treasury determines eligibility and allocations for CPP funds after consultation with the applicable overseeing federal banking regulator. The responsible banking regulator—the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, or the Office of Thrift Supervision—makes a funding recommendation to the Treasury based on an assessment of the overall viability of the institution (excluding potential CPP funds). In addition, other factors could be considered, such as signed merger agreements with other financial institutions, confirmed equity investments, or any write downs on government sponsored enterprise stock that adversely affect the institutions. The Board conducts the analysis and makes recommendations to the Treasury for applications from state member banks of the Federal Reserve System. The Board is also designated to analyze and make recommendations on applications from certain bank holding companies. The primary federal regulator for the lead bank of each holding company analyzes and makes recommendations on the application from the holding company; if a question exists, the federal banking regulators consult to identify the appropriate regulator to analyze the application and make the recommendation.

Under the CPP, Treasury provides funds to viable financial institutions through the purchase of preferred stock shares or senior securities, at market value, on standardized terms. The minimum subscription amount available to a participating institution is 1 percent of its risk-weighted assets. The maximum subscription amount is the lesser of \$25 billion or 3 percent of the risk-weighted assets. Financial institutions participating in the CPP issue either senior preferred shares, preferred shares, or senior securities. Senior preferred shares and preferred shares pay Treasury a 5 percent dividend for the first five years following Treasury's investment, and a rate of 9 percent per year thereafter. Senior securities pay Treasury a 7.7 percent interest rate for the first five years, and a rate of 13.8 percent per year thereafter. Publicly-traded financial institutions also issue warrants to Treasury to purchase common stock having an aggregate market price equal to 15 percent of the senior preferred investment on the date of investment. These warrants provide taxpayers with an opportunity to participate in the equity appreciation of the institution. Private financial institutions grant warrants for additional shares of preferred stock equal to 5 percent of the investment on the date of investment, which are exercised immediately and pay dividends of 9 percent. Subchapter-S corporations grant warrants for additional senior securities equal to 5 percent of the investment on the date of investment, which

are exercised immediately and pay interest of 13.8 percent.¹ Institutions may repay Treasury under the conditions established in the purchase agreements.

CPP application forms were available from Treasury’s website, and interested Board-supervised institutions were to submit their completed applications to their respective Federal Reserve Bank prior to the established deadlines. Subsequent to the expiration of the deadlines for the initial four categories of institutions, Treasury announced the expansion of the CPP to encourage participation by qualified small community banks. Only viable banks with less than \$500 million of total assets are eligible to apply for funds up to 5 percent of their risk-weighted assets. For holding companies with more than one bank, each individual bank’s assets are to be aggregated and only holding companies with total assets of less than \$500 million are eligible. The application deadline for small community banks to apply is November 21, 2009. Institutions that have already been approved under the initial CPP program can increase their CPP funding to 5 percent of risk-weighted assets. However, few institutions have applied under this program—only three financial institutions since the end of our fieldwork in July 2009. Board officials stated that indications are that few additional institutions will apply before the deadline, given the conditions imposed upon institutions who participate and the negative impact on investors’ views of institutions’ financial stability if they request CPP funds. Table 1 shows the application deadlines for the various types of financial institutions.

Table 1. Application Deadlines by Type of Institution

Type of Institution	Application Deadline
Publicly Traded	11/14/2008
Privately Held	12/08/2008
Privately Held – Subchapter-S Corporation	02/13/2009
Mutual Organizations ²	05/14/2009
Small Community Banks	11/21/2009

Objectives, Scope, and Methodology

In addition to obtaining an overview of the Board’s CPP implementation, our audit objective was to assess the Board’s process and controls for reviewing CPP applications from Board-supervised financial institutions. To accomplish our objective, we identified and analyzed guidance provided by Treasury and procedures developed by the Board; assessed and compiled summary information on Board-supervised institutions that applied; interviewed staff in the Division of Banking Supervision and Regulation (BS&R) and the Federal Reserve Banks

¹ Subchapter-S corporation financial institutions refer to banks, savings associations, bank holding companies, or savings and loan holding companies that have made a valid election to be taxed under Subchapter S of Chapter 1 of the U.S. Internal Revenue Code.

² Mutual Organizations are depository institutions that are owned by their depositors.

responsible for reviewing CPP applications; and tested a sample of applications and case decision memoranda.

To test the Board's procedures, we selected a test date of March 25, 2009. As of that date, the Board had received 320 applications from Board-supervised institutions requesting \$42.9 billion in CPP funds.³ To test compliance with Treasury guidance, we extracted a random sample of 85 applications from the 320 applications. For these sampled applications, we analyzed case decision memoranda and other supporting documentation to evaluate the Board's processing of applications in compliance with guidance provided by Treasury and procedures internally developed by the Board.

Of the 320 applications, some of which were still pending review, 96 were recommended by the Board and approved and funded by Treasury as of March 25, 2009. To ensure the Board's recommendations to Treasury were consistent with Treasury's guidance that the recommended institutions are to be viable, we performed more detailed analysis of how examination reports and other data used in the ongoing supervision of the institutions were considered in the Board's analysis for the ninety-six funded applications. We also reviewed application attachments to identify any information regarding the institutions' intended use of the funds.

We also analyzed information from the Board's CPP database as of July 31, 2009, to obtain more recent status information on CPP applications. In addition, we discussed with Board officials the process for responding to and tracking outside contacts regarding CPP applications. We also reviewed available data on the status of redemptions made by Board-supervised financial institutions that received CPP funds.

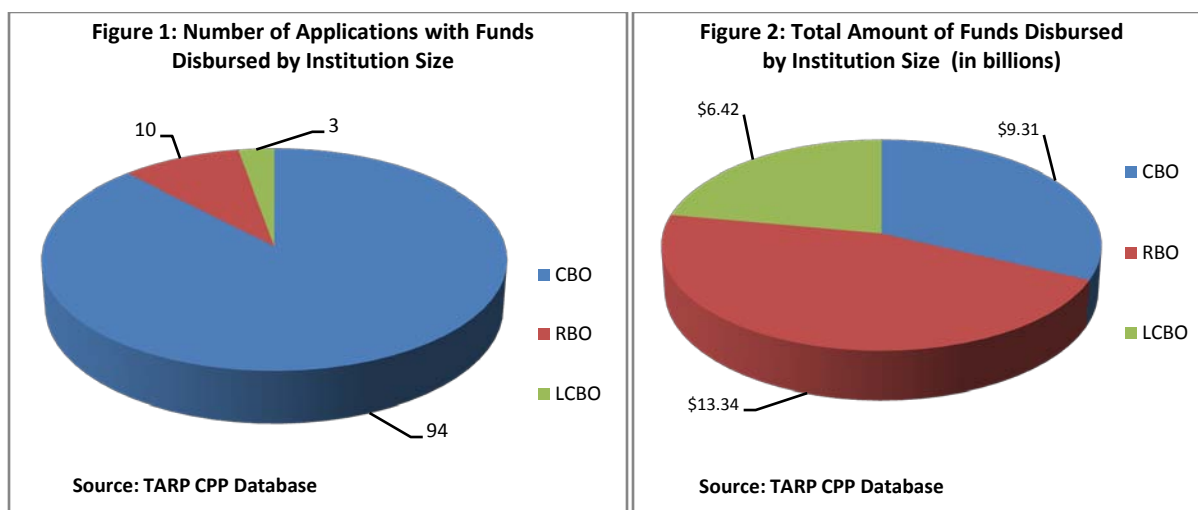
When Treasury announced the CPP, it also announced that nine major financial institutions already had agreed to participate in the plan. The Board was the primary banking supervisor for four of the nine institutions, which received \$25 billion in CPP funds. The four institutions have since repaid the CPP funds and paid Treasury approximately \$795 million in dividends. Due to the urgency of the financial crisis at the time EESA was signed, these institutions were approved by Treasury before CPP application procedures were developed and, hence, did not submit applications for review by the Board. As such, we did not analyze the application process for these four institutions.

Our review fieldwork was conducted from February through July 2009 in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

³ We did not review Mutual Organizations because their application timeframe began in April 2009, subsequent to our March 25, 2009, test date.

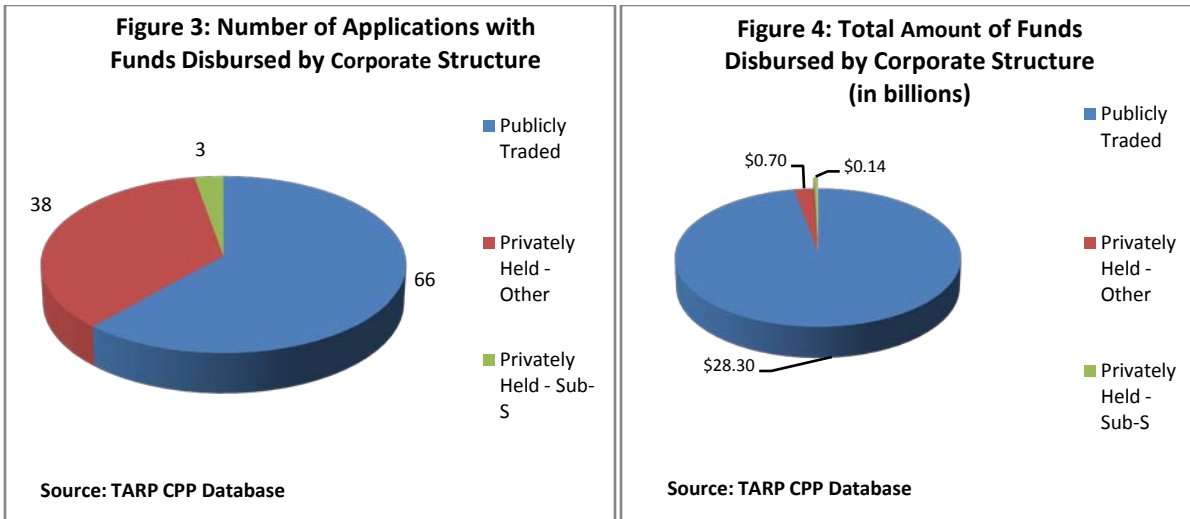
Overview of the Board’s CPP Implementation

As of July 2009, the Board received and reviewed 325 applications requesting approximately \$42.9 billion in capital, with the Board recommending and Treasury approving and disbursing a total of approximately \$29.1 billion to 107 financial institutions.⁴ These funds were disbursed to publicly traded, privately held, and Subchapter-S corporation financial institutions across Federal Reserve Bank districts, comprising community banking organizations (CBOs), regional banking organizations (RBOs), and large complex banking organizations (LCBOs). CBOs are small banks with less than \$10 billion in assets, and RBOs have assets greater than \$10 billion that are not LCBOs. LCBOs have greater than \$10 billion in assets, have been designated for their size and complexity, and may include foreign and domestic institutions. The majority of institutions funded were CBOs, while the funds disbursed were somewhat more evenly spread across the different sizes of financial institutions, as depicted in the figures below.

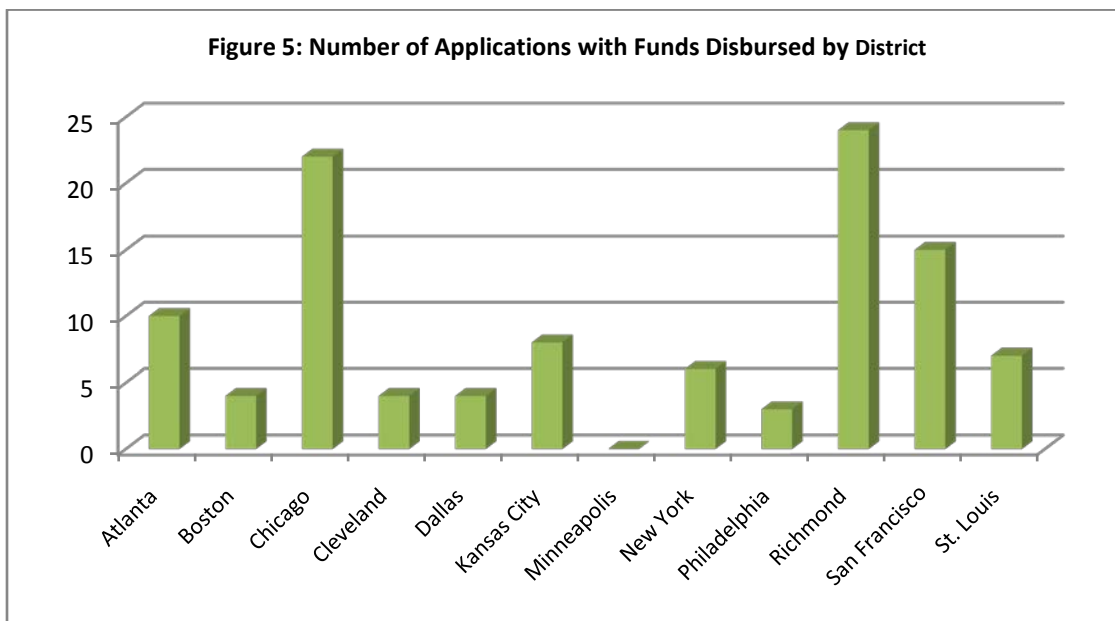


With regard to the corporate structure of the funded institutions, the majority were publicly traded institutions, which received the vast majority of capital, as shown in figure 3 and figure 4.

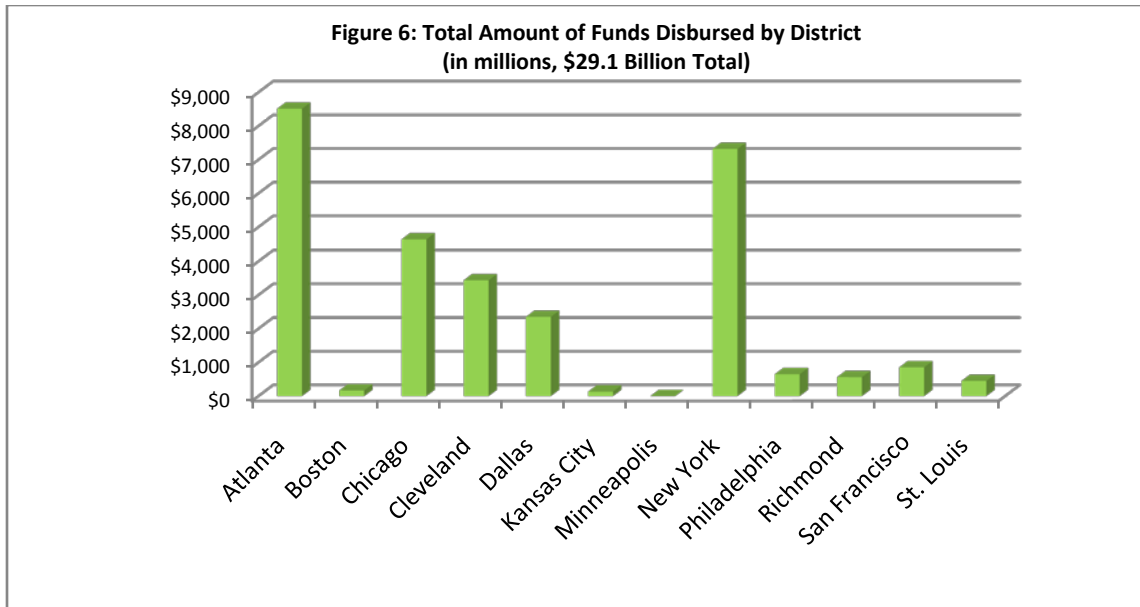
⁴ The funds identified as disbursed do not include the \$25 billion disbursed to the four major financial institutions Treasury approved without applications being submitted to the Board for review.



CPP-funded financial institutions included institutions across all Federal Reserve Bank districts, except for Minneapolis, as shown in the figures below. According to Board officials, the Board recommended seven of sixteen applications from the Minneapolis district for approval. While three of these applications were in process at Treasury at the time of our review, four of the institutions were approved but later chose not to take the funds for various reasons, and withdrew their applications.⁵



⁵ Of the remaining nine institutions, one is in process at the Board, and the other eight withdrew before a case decision memorandum was prepared by the Reserve Bank.



Of the 325 applications received, the Board recommended 128 (Treasury approved 123 and has 5 still in process); and 39 are still in process at the Board. According to the Board’s CPP database, the other 158 institutions that applied have withdrawn their CPP applications. According to Board officials, these 158 institutions include those that were not recommended, as well as institutions that were recommended but later chose not to take the funds (the latter were not counted in the above 128). The majority of these 158 institutions were viable and, hence, eligible for CPP funds, based on Treasury’s criteria. According to Board and Reserve Bank officials, these institutions may have decided to withdraw based on requirements imposed upon institutions who participated in the CPP or because they wanted to demonstrate their viability to their investors given the deteriorating financial environment at the time.

Proposed Use of CPP Funds

Guidance provided by Treasury for qualifying institutions interested in applying for CPP funds did not impose restrictions on institutions’ use of CPP funds and did not require the applicants to state their intended use of CPP funds. However, some Board-supervised institutions voluntarily provided attachments to their applications that stated their intended use of the funds. Of the ninety-six Board-supervised institutions recommended for approval by the Board and funded by Treasury as of March 25, 2009, nineteen indicated proposed uses (including multiple uses) for CPP funds, as summarized in table 2.⁶

⁶ For information purposes, the Special Inspector General for TARP issued a report on financial institutions’ use of TARP funds entitled, *SIGTARP Survey Demonstrates that Banks Can Provide Meaningful Information on Their Use of TARP Funds*, dated July 20, 2009.

Table 2. Overview of Proposed Use of Funds

Proposed Use of Funds	Applications
Increase lending	14
Acquire other banks	9
Improve liquidity and capital	5
Support bank operations	3
Remove troubled loans off books	1

Institutions' Redemption of CPP Funds

We identified that, as of March 2009, financial institutions began to repay the funds extended, referred to as redemptions, including payment of dividends on the preferred stock and senior securities. As of July 2009, four financial institutions had redeemed \$5.1 billion and paid \$123 million in dividends. These redemptions are in addition to the four large Board-regulated institutions that received \$25 billion in CPP funds very early in the process, which have repaid the \$25 billion back to Treasury, as well as \$795 million in dividends.

The appropriate Reserve Bank is responsible for analyzing whether a requested redemption would impact the company's ability to maintain adequate capital levels over the next one to two years, assuming continued or even worsening economic conditions. If the preferred stock or senior securities will be redeemed from a bank holding company, the Reserve Bank will consider whether the holding company will still be able to serve as a source of financial and managerial strength to its subsidiary bank(s) after the redemption. This analysis will consider various factors, such as the level and composition of capital, earnings, asset quality, and liquidity. The Board has developed guidance and a template for Reserve Banks to use in preparing a Redemption Request Decision Memorandum.

As stated previously, four of five application deadlines have passed. Although the deadline for the fifth category, small community banks, is not until November 21, 2009, few additional applications are expected. Thus, it appears that the Board's CPP activities will be shifting to processing redemption requests.

Findings, Conclusions, and Recommendations

Overall, we found that the Board's limited internal procedures were consistent with Treasury's guidance for reviewing TARP CPP applications and making recommendations for funding. We found that the Board generally complied with Treasury guidance and its own internal procedures in analyzing applications, although in our sample we identified some compliance deficiencies and areas for improvement, such as incomplete documentation on the analysis of the institutions' capital, asset quality, earnings, and liquidity (CAEL) components; missing quality assurance certifications by Reserve Bank senior officials; and a lack of documentation on the analysis of the institutions' ongoing viability. Nonetheless, due to compensating controls at the Board, we did not identify any instances where these deficiencies led to approval of financial institutions

that did not meet the eligibility criteria or that otherwise should not have been approved. We found that the Board received limited guidance from Treasury in the early stages of the CPP program regarding what analysis should be performed to determine the viability of the financial institutions applying for CPP funds. As the Board began reviewing applications under the limited guidance, Board officials raised issues to Treasury officials that resulted in additional Treasury guidance and Board procedures. As a result, the Board's case decision memoranda on CPP applications early in the program contained less detail on the analysis performed than those prepared later in the process.

We also reviewed the Board's process for responding to outside contacts regarding CPP applications. While we did not identify any deficiencies, we did identify further controls that could help ensure such contacts are appropriately handled and documented.

The Board's Process and Controls for Reviewing CPP Applications

The Board received limited guidance from Treasury for evaluating CPP applications when the CPP program began, due to the urgency of the financial crisis and the need to expeditiously provide additional capital to financial institutions. Treasury's guidance to the Board was issued quickly after EESA was signed into law. As the Board began analyzing applications under the limited guidance, it developed its own internal procedures and controls for analyzing CPP applications and determining whether to recommend institutions for funding. The Board continued to expand its internal procedures and guidance to Reserve Banks as additional guidance was received from Treasury. We found that the Board's internal procedures support Treasury's guidance for reviewing applications and making recommendations for funding. The Board's overall process to evaluate an institution's application includes the applicable Reserve Bank's evaluation of the institution's viability, along with a quality assurance review. As an additional control, the Board performs an independent evaluation prior to making the final Treasury recommendation.

On October 20, 2008, Treasury issued overall guidance, entitled *Process for Evaluation of QFI [Qualified Financial Institutions] Participation in the TARP Capital Purchase Program*, to all federal banking agencies. The guidance states that Treasury will determine eligibility and allocation of funding to institutions in the TARP CPP, after consultation with the appropriate federal banking agency. The limited guidance instructed the federal banking agencies to classify each application in one of three categories: Presumptive Approval, Presumptive CPP Council Review, and Presumptive Denial. Category classification is based on the institution's CAMELS rating, the time lapse since the most recent examination, and the acceptability of financial performance ratios.⁷ The quantitative performance ratios relate to acceptable percentages for classified assets, non-performing loans, other real estate owned, and construction and development loans.

⁷ CAMELS refers to the Uniform Financial Institution Rating System adopted by the Federal Financial Institutions Examination Council in November 1979, and subsequently amended. A composite CAMELS rating is based on an evaluation and rating of six components of an institution's financial condition and operations – Capital adequacy, Asset quality, Management capability, Earnings, Liquidity, and Sensitivity to market risk. Ratings are assigned based on a 1 to 5 numerical scale, with 1 being the highest rating and 5 the lowest rating.

Institutions initially placed in the Presumptive Approval category must have a composite rating of “1” or “2” from a banking oversight examination within the last six months, or a rating of “2” or “3” with acceptable performance ratios.

Institutions placed in the Presumptive CPP Council Review category have either a composite rating of “2” for which the last examination rating is more than six months old and have overall unacceptable performance ratios, or a composite “3” with overall unacceptable performance ratios. These institutions receive an additional review by the CPP Council, which is an interagency committee made up of senior officials from the federal banking agencies. The CPP Council review is intended to be a consensus-building meeting where federal banking regulators present applications under their purview to the other regulators. The CPP Council then votes on providing a recommendation to Treasury. Cases presented to the CPP Council can be approved, denied, or remanded to another CPP Council meeting, after additional analysis, for further discussion.

Institutions placed in the Presumptive Denial category have composite ratings of “4” or “5.” The Reserve Banks usually suggest that they withdraw their applications.

Of the ninety-six institutions that the Board recommended and Treasury approved for funding as of March 2009, most were a composite “2” after their most recent examination, as shown in the following table.

Table 3. Composite Ratings for Funded Institutions, as of March 25, 2009

Composite Rating	Number of Institutions
1	8
2	80
3	8
Total	96

Treasury guidance also required consideration of the institutions’ Community Reinvestment Act (CRA) ratings. CRA is designed to encourage commercial banks and savings and loan associations to meet the needs of borrowers in all segments of their communities, including low and moderate income neighborhoods. The CRA requires federal banking agencies, in connection with their safety and soundness examinations, to also assess the institutions’ performance in helping to meet the credit needs of their communities. Each institution is evaluated within the context of information about the institution (capacity, constraints, and business strategies), its community (demographic and economic data, lending, investment, and service opportunities), and its competitors and peers. Upon completion of a CRA examination, an overall CRA rating is assigned using a four-tiered rating system: “Outstanding,” “Satisfactory,” “Needs Improvement,” or “Substantial Noncompliance.” The ninety-six institutions funded as of March 2009 were either Satisfactory or Outstanding, except for one that was classified as Needs Improvement. We reviewed the case decision memorandum for the institution that was rated

Needs Improvement and determined that the Board identified the institution as meeting the criteria for a recommended approval, based on Treasury guidance.⁸

To supplement Treasury's guidance, the Board provided additional limited guidance for internal staff and the Reserve Banks' staff to use in processing the TARP CPP applications and case decision memoranda. Specifically, in late October 2008, the Board sent an email message to the Reserve Banks outlining various administrative procedures for processing institutions' applications and requests for application withdrawals, submitting analysis documentation to the Board, and including quality assurance statements from Reserve Bank officers. After further discussions with Treasury officials, the Board sent an additional email message to the Reserve Banks regarding additional analysis to perform in reviewing the applications and developing case decision memoranda on the adequacy of the financial institutions' CAEL components. However, the email messages did not include detail on the analysis to be performed on the CAEL components or what should be included in a quality assurance review at the Reserve Banks.

The Board's procedures require a Reserve Bank analyst to review an institution's application for completeness and to prepare a case decision memorandum. The case decision memorandum is based on a Treasury-designed template for documenting certain financial ratios and includes a discussion on the viability of the institution. The analyst is also responsible for entering information into the Board's CPP database. A Reserve Bank officer is required to perform a quality review of the case decision memorandum and the CPP database information before submitting the application and case decision memorandum to the Board for further review and disposition. We surveyed the twelve Reserve Banks and found that all twelve developed internal procedures for analyzing CPP applications, in addition to the Board's emailed guidance, although only five Reserve Banks had formal documented procedures.

Once the Board receives the application and case decision memorandum, the procedures followed depend on each institution's assigned category. If the institution is in the Presumptive Approval category, a Board analyst performs a quality review of the case decision memorandum. If the institution is in either of the other two categories, a Board analyst performs a quality review of the case decision memorandum, as well as an independent evaluation of the institution's viability to ensure the data and analysis are current. As discussed above, applications in the Presumptive Approval category and the associated case decision memoranda are sent directly to Treasury. For the other two categories, the institutions' documents are sent to the CPP Council for review or back to a Reserve Bank for further discussion with the institution and evaluation.

The Board's Compliance with Treasury Guidance and Board Procedures

Recommendation 1. As the CPP application phase draws down and the Board moves forward with analyzing redemption requests from CPP-funded institutions, we recommend that the Board incorporate lessons learned from the CPP application review process to help ensure that a complete, formal, and documented set of procedures is implemented and followed to further the consistent and thorough analysis of redemption requests.

⁸ Two of the approved institutions were not commercial banks subject to CRA requirements.

Although not required by Treasury, we believe that formal, detailed, and documented procedures would have provided the Board and the Reserve Banks additional assurance of consistently and completely analyzing CPP applications. We recognize that the Board received limited guidance from Treasury, and that the urgency of the financial crisis required expeditious actions on the part of Treasury and the Board in analyzing applications. A complete, formal, and documented set of procedures in place for redemptions can act to ensure consistent and thorough analysis of redemption requests.

Overall, we found that the Reserve Banks generally evaluated and processed applications in accordance with Treasury's limited guidance and the Board's emailed supplemental procedures. We identified some compliance deficiencies by the Reserve Banks in following certain procedures and documenting the analysis of the financial institutions' health and viability. However, we did not identify any cases where the Board recommended institutions that were not eligible to or otherwise should not have been recommended to Treasury. We found that the additional evaluation performed at the Board, after the applications were analyzed at the Reserve Banks, provided important compensating controls, in addition to the analysis performed by the CPP Council for certain institutions.

During our testing, we found that the Reserve Banks' preparation of case decision memoranda complied with Treasury's guidance and, in most instances, the Board's guidance. As discussed previously, in October 2008, the Board sent a brief email to the Reserve Banks requiring that case decision memoranda include an analysis of the institutions' CAEL components as a measure of the institutions' viability, and that a senior Reserve Bank official perform a quality review of each case decision memorandum. However, seven of the eighty-five case decision memoranda we reviewed did not have a complete discussion of the CAEL components. Specifically, we found that four did not include a liquidity discussion, two did not include a discussion on the institution's capital position, and one did not include discussion of the institution's liquidity or earnings. Board staff stated that for these institutions, other information was available on the relevant financial factors. However, the Board's email guidance regarding analysis and discussion of the CAEL factors set forth an analytical framework for assuring that the viability of the financial institution was adequately analyzed and documented in deciding whether to recommend the institution for approval.

We also found that the Reserve Banks usually included the required quality assurance statement from a senior Reserve Bank official regarding a quality review of the case decision memorandum. The Board's October 2008 email guidance to the Reserve Banks directed that all CPP evaluations include a quality assurance statement from a senior Reserve Bank official. This statement provides additional assurance to the Board that the evaluation underwent the necessary review and analysis. However, the Board's email guidance did not detail the type of quality assurance review to be performed. We found three instances out of eighty-five applications sampled where the Reserve Banks submitted case decision memoranda to the Board without the required quality assurance statement. Board staff explained that one of the three institutions was a CBO and received an additional review by BS&R's CBO section, and that the other two evaluations were jointly prepared by Board and Reserve Bank staff. Nevertheless, the Board required a quality assurance review and a senior official's statement as an additional control to ensure a complete and sufficient analysis of each institution's application.

In addition, we determined that the Reserve Banks placed financial institutions into their correct category based on Treasury's guidance, with one exception out of the eighty-five applications we reviewed. We identified one application that a Reserve Bank erroneously placed into the Presumptive Approval category instead of in the Presumptive CPP Council Review category, and submitted it to the Board. However, in its independent evaluation, the Board determined that the institution was actually in the Presumptive CPP Council Review category, and appropriately submitted the application to the CPP Council for review.

To further assess the overall effectiveness of the process followed by the Board in recommending institutions for approval and whether any of those institutions recommended by the Board have since declined, we performed further detailed analysis of the viability of the ninety-six institutions that were approved and funded as of March 2009. In analyzing safety and soundness examinations as well as supervisory information used in monitoring institutions between examinations, we determined that nine of the ninety-six did experience a rating decline or showed an indication of a potential rating decline since the case decision memorandum was prepared. However, as of July 2009, none of the nine had subsequent examinations that rated the institutions as a composite "4" or "5," which would have placed them in the Presumptive Denial category.

We identified that case decision memoranda for three of the nine did not fully address the financial condition of the institution and the issues identified in examination reports and supervisory data that had the potential to lead to a rating decline. The Board forwarded the applications for two of the three institutions to the CPP Council for review, and CPP Council documentation indicated that the additional supervisory information was discussed during the CPP Council meeting. However, the other institution's application was classified in the Presumptive Approval category and sent directly to Treasury and approved. Subsequent to Treasury's approval, this institution underwent a target examination that confirmed issues identified in the earlier supervisory information, but as of the end of our fieldwork in July 2009, the institution had not deteriorated to a composite "4" or "5" rating, which would have placed it in the Presumptive Denial category. We note that this case decision memorandum was prepared very early in the process, prior to the Board providing email messages to the Reserve Banks requesting analysis of the status of each of the CAEL components, and Treasury's limited guidance did not detail what was required to determine the overall viability of the institution.

Although not required by Treasury, we believe that formal, detailed, and documented procedures would have provided the Board and the Reserve Banks with additional assurance of consistently and completely analyzing CPP applications. While we did not find that the Board recommended any financial institutions that were not eligible or otherwise should not have been recommended, we found several cases where the Reserve Banks did not provide documentation on all of the required analysis or perform quality assurance reviews, one case where the financial institution was misclassified, and three cases where the case decision memoranda lacked documentation on the analysis of the recent examination data and potential for a rating decline.

As stated earlier, few applications are now being received by the Board under the expanded CPP program. Only three applications have been received since the end of our fieldwork, and Board officials stated that indications are that few additional institutions will apply before the

November 21, 2009, deadline given the conditions imposed upon institutions who participate, and the negative impact on investors' views of institutions' financial stability if they request CPP funds. Going forward, with the Board focusing on reviewing redemption requests from the institutions that have received CPP funds, we believe lessons learned from the Board's CPP application review process should be incorporated into the redemption analysis process. A complete, formal, and documented set of procedures will act to further the consistent and complete analysis by Reserve Banks of redemption requests and complement the reviews performed by Board officials.

Outside Contacts and Discussions with CPP Applicants

Recommendation 2. We recommend that the Board develop a case tracking system to document relevant communications between Reserve Bank staff and institutions regarding their CPP applications and redemption requests.

We also reviewed the Board's controls for ensuring that any outside contacts do not influence the process for analyzing CPP applications. Overall, we found that the Board developed a tracking system to document questions from, and responses to, outside contacts regarding the CPP. However, not all communications between the Reserve Bank staffs and institutions were formally documented. Having a case tracking system to document relevant communications between Reserve Bank staffs and officials from Board-supervised institutions regarding CPP applications and redemption requests is important because it would provide the Board with additional assurance that such communications are appropriately handled and available for later review.

In the early stages of the CPP, BS&R set up a call center to answer questions from interested parties about the CPP, and tracked and documented these inquiries and their resolution. The Board also has a general process for recording and responding to all formal written external inquiries from outside parties. However, communications and discussions between the Reserve Bank staffs and institutions are not required to be formally documented. The CPP process involves Board-supervised institutions obtaining CPP application forms from Treasury's website and sending the completed applications to their respective Federal Reserve Bank. According to Reserve Bank officials, institutions are able to contact Reserve Banks with questions about completing the application and, once submitted, institutions do inquire about the status of their applications. In addition, Reserve Bank staff informed us that if an institution does not meet Treasury's requirements, the Reserve Bank staff has conversations with the institution about withdrawing its application. If an institution decides to withdraw its application, it is required to submit a formal written request to the Reserve Bank. The written request is forwarded to the Board, but any conversations between the Reserve Banks and the institutions are not required to be formally documented. To ensure such communications are appropriately handled in carrying out the CPP process, we believe discussions between Reserve Banks and financial institutions regarding their CPP applications, including discussions about an institution's decision not to file an application or to withdraw its application, should be documented. Going forward, as the Board focuses on redemption requests, we believe such communications with regard to redemption requests should also be documented.

Analysis of Comments

We provided a copy of our report to the Acting Director of BS&R for review and comment. Her response, included as Appendix 1, indicates agreement with the findings of the review and discusses steps to address the recommendations of the report. With respect to recommendation 1, the acting director noted that the Board staff already has developed written procedures for the Reserve Banks to follow in considering redemption requests. However, as recommended, BS&R may amend the formal guidance provided to the Reserve Banks as appropriate and as experience is gained with the process. With respect to recommendation 2, while the acting director believes that the Reserve Banks have been conscientious in documenting their work related to the CPP, she recognizes that additional guidance would result in more consistency in tracking communications. As a result, BS&R will develop additional internal guidance for the Reserve Banks to follow in documenting communications with institutions participating in the CPP.

Appendixes

Appendix 1 – Division Director’s Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MEMO

DATE: September 28, 2009

TO: Elizabeth Coleman, Inspector General

FROM: Norah Barger, Acting Director */signed/*

SUBJECT: Report on the Board’s Processing of Applications for the Capital Purchase Program under the Troubled Asset Relief Program

The staff of the Division of Banking Supervision and Regulation has reviewed the *Report on the Board’s Processing of Applications for the Capital Purchase Program under the Troubled Assets Relief Program (Report)* that was prepared by the Office of the Inspector General (OIG). The report concluded that the Board’s procedures were consistent with the Department of Treasury’s guidance and that Federal Reserve recommendations generally reflected compliance with Treasury guidance and the Board’s internal procedures. In addition, the report recommended (1) that the Board ensure that formal, documented procedures are maintained to guide the review of TARP redemption requests and (2) that the Board develop a case tracking system to document relevant communications between Reserve Bank staff and institutions regarding their Capital Purchase Program applications and redemption requests.

We concur with the findings of the review and will take steps to address the recommendations of the report. With respect to recommendation 1, we note (and the report acknowledges on page 13) that the Board staff already has developed written procedures for the Reserve Banks to follow in considering redemption requests. These procedures detail a uniform set of factors that must be considered in evaluating redemption requests and require the preparation of a standard case decision memorandum documenting the analysis and conclusions of the Reserve Banks. Factors considered include changes in the condition and performance of the applicant in the time since receiving TARP funds, the projected ability of the company to maintain capital levels appropriate to its risk profile over the next two years after redeeming TARP funds, the adequacy of the company’s capital planning process, conformance with supervisory guidance and regulations related to the payment of dividends, and the views of the supervisor(s) of bank subsidiaries of bank holding companies. Completed TARP redemption case decision memoranda are reviewed for adequacy by Board staff and retained to document the analysis of requests. As recommended, we may amend the formal guidance provided to the Reserve Banks as appropriate and as experience is gained with the process.

Appendix 1 – Division Director’s Comments (con’t)

With respect to recommendation 2, while we believe that the Reserve Banks have been conscientious in documenting their work related to the Capital Purchase Program, we recognize that additional guidance would result in more consistency in tracking communications. As a result, we will develop additional internal guidance for the Reserve Banks to follow in documenting communications with institutions participating in the Capital Purchase Program.

The Division very much appreciates the opportunity to comment on the IG’s report and welcomes the report’s observations and comments on how we can improve procedures for implementing the Treasury’s Capital Purchase Program.

Appendix 2 – Principal Contributors to this Report

Victor H. Calderon, Senior Auditor

Keisha R. Turner, Auditor

Peter Sheridan, Project Manager

Andrew Patchan, Jr., Assistant Inspector General for Audits and Attestations

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