OFFICE OF INSPECTOR GENERAL

Evaluation Report 2016-SR-B-005

Review of the Failure of NBRS Financial

March 31, 2016

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
CONSUMER FINANCIAL PROTECTION BUREAU

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Abbreviations

ALLL	allowance for loan and lease losses
Board	Board of Governors of the Federal Reserve System
BRAC	Base Realignment and Closure
CBEM	*Commercial Bank Examination Manual*
CFO	Chief Financial Officer
CLD	construction, land, and land development
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 Richmond	Federal Reserve Bank of Richmond
MOU	memorandum of understanding
OIG	Office of Inspector General
PCA	prompt corrective action
SR Letter	Supervision and Regulation Letter
State	Maryland Office of the Commissioner of Financial Regulation
TARP	Troubled Asset Relief Program

Executive Summary:

Review of the Failure of NBRS Financial

2016-SR-B-005 March 31, 2016

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 NBRS Financial because the failure presented unusual circumstances that warranted an in-depth review.

Background

NBRS Financial, located in Rising Sun, Maryland, operated as a national bank serving local communities for more than 120 years before transitioning from a national to a state charter in 2002. The bank was supervised by the Federal Reserve Bank of Richmond (FRB Richmond) and the Maryland Office of the Commissioner of Financial Regulation (State). On October 17, 2014, the State closed NBRS Financial and appointed the Federal Deposit Insurance Corporation as receiver.

Findings

NBRS Financial failed because of the convergence of several factors. The bank consolidated authority in an individual who served as the President, Chief Executive Officer, and Chairman of the board of directors. This individual's dominant influence on the bank's operations limited the institution's ability to overcome its deteriorating financial condition. The President surrounded himself with an inexperienced senior management team while allegedly engaging in improper business practices for his own benefit. In addition, NBRS Financial's board of directors exercised ineffective oversight of the bank's operations. The board of directors approved a strategic plan that relied heavily on a perceived economic opportunity for the local economy that never materialized, and it also failed to adapt to changing market conditions in a timely manner. The bank developed high concentrations in commercial real estate and extended large loans to single borrowers, which exacerbated the bank's concentration risk and resulted in numerous regulatory violations. NBRS Financial's board of directors and management also failed to establish adequate credit risk management practices and internal controls commensurate with the risks within the bank's loan portfolio. These concentrations and poor credit risk management practices, along with a deteriorating real estate market, resulted in asset quality deteriorations, significant losses, and an erosion of capital.

With respect to supervision, FRB Richmond complied with the applicable examination frequency guidelines, conducted regular offsite monitoring, and implemented applicable prompt corrective action provisions during the time frame under review—2006 through 2014. FRB Richmond's supervisory activity during this period included formal enforcement actions in the form of a written agreement and a prompt corrective action directive. Our review of FRB Richmond's supervision of NBRS Financial revealed that FRB Richmond took strong supervisory action in 2009 and seized an opportunity to take even stronger supervisory action in 2012. Our review resulted in one finding related to the potential fraud and insider abuse risks that dominant management officials can present. We observed this theme with NBRS Financial and reported on it in prior failed bank reviews.

Recommendation

Our report recommends that the Board of Governors of the Federal Reserve System develop guidance or training related to the opportunity to highlight potential indicators of internal abuse or heightened fraud risk in situations involving dominant officials. The Director of the Division of Banking Supervision and Regulation concurred with our recommendation and outlined planned corrective actions to address the recommendation.

Summary of Recommendations, OIG Report 2016-SR-B-005

Recommendation number	Page	Recommendation	Responsible office
1	21	Develop supervision guidance or training to help Reserve Banks a. identify the circumstances in which the presence of dominant bank officials may heighten the risk of fraud or insider abuse. Based on our failed bank reviews, we believe these circumstances include, but are not limited to, • weak internal control functions • ineffective governance and oversight • frequent turnover of senior management officials • significant internal control weaknesses, including segregation of duties issues b. take appropriate actions to address these conditions.	Division of Banking Supervision and Regulation

Office of Inspector General

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

March 31, 2016

MEMORANDUM

TO: Michael 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 2016-SR-B-005: *Review of the Failure of NBRS Financial*

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 NBRS Financial. This report reflects the results of our review.

We provided you with a draft of our report for review and comment. In your response, you outlined actions that will be taken to address our recommendation. We have included your response as appendix C to our report.

We appreciate the cooperation that we received from the Federal Reserve Bank of Richmond and the Board of Governors of the Federal Reserve System during our review. Please contact me if you would like to discuss this report or any related issues.

cc: Jack Jennings
Kevin Bertsch
Jennifer Burns
Richard Watkins
William Mitchell
J. Anthony Ogden

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Introduction

Background

NBRS Financial Bank, located in Rising Sun, Maryland, operated as a national bank serving local communities for more than 120 years before transitioning from a national to a state charter in 2002. During that transition, the institution became a state chartered bank supervised by the Maryland Office of the Commissioner of Financial Regulation (State) and changed its name to NBRS Financial. In the same year, NBRS Financial became a member institution supervised by the Federal Reserve Bank of Richmond (FRB Richmond), under delegated authority from the Board of Governors of the Federal Reserve System (Board).[1] The bank was locally owned and managed since its inception and provided a broad range of services to its individual and business customers, with a focus on retail deposits and real estate lending. NBRS Financial's branch network consisted of a branch location in each of the following five counties: Cecil and Harford Counties in Maryland and Chester, Lancaster, and York Counties in Pennsylvania.

On October 17, 2014, the State determined that the bank's financial condition had become critically deficient and, as a result, closed NBRS Financial and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated the cost of the bank's failure to the Deposit Insurance Fund (DIF) at $24.3 million. Section 987 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), an act that amends section 38(k) of the Federal Deposit Insurance Act, defines a material loss to the DIF as an estimated loss in excess of $50 million.[2] Although the estimated loss to the DIF associated with this failure did not meet the threshold for materiality, for failures beneath the material loss threshold, the Dodd-Frank Act requires our office to assess the circumstances surrounding the failure. Upon identifying unusual circumstances warranting additional review, our office conducts an in-depth review similar to a material loss review.[3] As a result of our initial review, we determined that NBRS Financial's failure presented unusual circumstances that warranted an in-depth review for several reasons, including questionable business transactions and practices involving senior management, the bank being in troubled condition during the five years prior to failure, and its receipt of Troubled Asset Relief Program (TARP) funds.[4]

Objectives, Scope, and Methodology

When a loss to the DIF presents unusual circumstances, section 38(k) of the Federal Deposit Insurance Act requires the Inspector General of the appropriate federal banking agency to prepare

1. Prior to its failure, NBRS Financial was the sole subsidiary of the Rising Sun Bancorp bank holding company.

2. The $50 million materiality threshold applied to losses that occurred on or after January 1, 2014.

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

4. NBRS Financial received approximately $6 million in TARP funds. The bank's holding company initially received the $6 million and transferred the funds to NBRS Financial.

a report in a manner that is consistent with the requirements of a material loss review. Specifically, the appropriate federal banking agency is required to 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

To accomplish our objectives, we reviewed supervisory activity of NBRS Financial from 2006 through 2014.[5] 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 State, and the Board. We also reviewed surveillance reports, enforcement actions, examination reports, examination workpapers prepared by FRB Richmond, correspondence, and relevant FDIC documents. In addition, we obtained and reviewed market data, including general economic, demographic, and real estate data.

We conducted this evaluation from May 2015 to February 2016 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 the report include a glossary of key banking and regulatory terms and a description of the CAMELS rating system.

5. The Board's Division of Banking Supervision and Regulation leads the execution of supervisory responsibilities by coordinating and participating in supervisory programs and activities. Under delegated authority from the Board, the respective Federal Reserve Banks conduct banking supervision activities, such as onsite examinations and offsite monitoring.

Causes of the Failure

NBRS Financial failed because of the convergence of several factors. The bank consolidated authority in an individual who served as the President, the Chief Executive Officer, and the Chairman of the board of directors (hereafter President). This individual's dominant influence on the bank's operations limited the institution's ability to overcome its deteriorating financial condition. The President surrounded himself with an inexperienced management team while allegedly engaging in improper business practices for his own benefit. In addition, NBRS Financial's board of directors exercised ineffective oversight of the bank's operations. The board of directors approved a strategic plan that relied heavily on a perceived economic opportunity for the local economy from the U.S. Department of Defense's Base Realignment and Closure (BRAC) process that never materialized, and the board failed to adapt to changing market conditions in a timely manner.[6]

Ineffective board of directors and management oversight also allowed significant risks to develop and persist. Specifically, the bank developed high concentrations in commercial real estate (CRE) and extended large loans to single borrowers, which exacerbated the bank's concentration risk and resulted in numerous regulatory violations. The board of directors and management failed to establish adequate credit risk management practices and internal controls commensurate with the risks within the bank's loan portfolio. These concentrations and poor credit risk management practices, along with a deteriorating real estate market, resulted in asset quality deterioration, significant losses, and an erosion of capital. The board of directors and management could not resolve these fundamental weaknesses. Escalating losses depleted earnings and eroded capital, which prompted the State to close NBRS Financial and appoint the FDIC as receiver on October 17, 2014.

Corporate Governance Weaknesses

From 2009 to 2014, FRB Richmond and State examiners identified several corporate governance weaknesses at NBRS Financial. These weaknesses included a dominant President, who undermined the effectiveness of key control functions, and an ineffective board of directors and inexperienced senior management team. The presence of these conditions created the opportunity for alleged insider abuse.

6. BRAC is the congressionally authorized process for the U.S. Department of Defense's reorganization of its military base structure. Through this process, the department recommends base closures and realignment to a commission for approval; the most recent commission was formed in 2005 and is composed of nine individuals who were nominated by President George W. Bush. The purpose of this reorganization is to increase operational readiness and facilitate new ways of doing business.

Dominant President's Actions Undermined Key Control Functions and Created the Opportunity for Alleged Insider Abuse

In the September 2009 examination, FRB Richmond examiners stated that NBRS Financial's President "has a dominant role over operating policies, procedures and the overall financial condition of the bank and the bank holding company." During that same examination, FRB Richmond recommended that the board of directors review the President's duties to determine whether some of those responsibilities should be delegated to others. Further, examiners noted in the 2009 examination that the bank experienced significant turnover in the lending function, which resulted in the President directly managing a substantial number of complex loans. FRB Richmond examiners also noted that the President "was the only person able to provide answers to questions regarding numerous functions." For example, examiners stated that the bank's Chief Financial Officer (CFO) deferred questions regarding several general ledger entries to the President. NBRS Financial experienced frequent turnover in its CFO position; two CFOs resigned during the five-year period from 2004 to 2009. In our opinion, the President's apparent direct involvement with general ledger entries coupled with his direct involvement in managing loans illustrates multiple violations of segregation of duties principles.[7]

NBRS Financial's President influenced certain staffing changes that, in our opinion, created the opportunity for alleged insider abuse by undermining the effectiveness of key control functions. From 2006 to 2014, examiners noted weaknesses in the bank's internal control environment. According to a State official, NBRS Financial moved the internal audit function in-house at the insistence of the President. FRB Richmond examiners noted in a January 2011 examination report that "the internal auditor may lack the expertise to effectively perform the duties required of the internal audit function." During a State examination that began in October 2011, examiners noted a recurring observation related to staff member inexperience in the internal audit function. As a result of frequent turnover in lending staff and weaknesses in senior executive positions, such as the internal auditor and CFO, NBRS Financial's President dominated many aspects of the bank's daily operations. In our opinion, this operating environment created the opportunity for insider abuse.

NBRS Financial's President allegedly engaged in improper business practices for his own benefit. As early as 2009, examiners found that the President's total outstanding debt of $1.2 million to NBRS violated a provision in Regulation O limiting loans to bank insiders.[8] In a September 2010 examination report, FRB Richmond and State examiners also identified questionable, entertainment-related credit card transactions on the President's corporate credit card and requested that NBRS Financial's board review the expenses. Despite examiners' concerns, the board of directors concluded that these expenses were not improper and reimbursed the President for them. Subsequently, in 2011, instead of using his corporate credit card to make charitable

7. The U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government* defines *segregation of duties* as the division or segregation of key management duties and responsibilities among different people to reduce the risk of error, misuse, or fraud. This includes separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets so that no one individual controls all key aspects of a transaction or event.

8. Regulation O governs any extension of credit by a member bank to an executive officer, director, or principal shareholder of that bank, of a bank holding company of which the member bank is a subsidiary, and of any other subsidiary of that bank holding company. The regulation also applies to any extension of credit by a member bank to a company controlled by a bank official and to a political or campaign committee that benefits or is controlled by an executive of the financial institution.

donations on behalf of the bank, the President charged the donations to his personal credit card and was later reimbursed.

In February 2012, NBRS Financial's board asked the President and a board member to resign for not disclosing their related interests in several loans. These two individuals allegedly borrowed more than $3 million in the names of various relatives without disclosing their apparent interests in the loan proceeds. Both the President and the board member allegedly misrepresented the sources of repayment and the purpose of the loans, which may have been for personal gain. Accordingly, NBRS Financial's management filed the appropriate notification forms related to these activities.

Ineffective Oversight by the Board of Directors

NBRS Financial increased its focus on CRE lending because of a perceived opportunity resulting from BRAC. In a 2007 report to the U.S. Department of Labor, the Maryland Department of Business and Economic Development predicted that (1) Maryland would gain an estimated total of more than 45,000 federal and private-sector jobs through BRAC over time and (2) more than 15,000 of the 45,000 jobs would be located in Cecil and Harford Counties. The report noted that the anticipated BRAC effect for the region was preliminary and needed to be reviewed in the context of the ever-changing dynamics of national-level defense decisions. NBRS Financial's board of directors chose to pursue this CRE-focused strategy despite the preliminary nature of the 2007 report.

NBRS Financial's board of directors approved a strategic direction focused on commercial lending that contributed to the bank's deteriorating condition. The success of the institution's strategic focus on CRE hinged on the anticipated strong local real estate market conditions resulting from BRAC. When the anticipated benefits from BRAC did not materialize, the board of directors was slow to react. In the bank's strategic plan for 2007–2010, NBRS Financial's board anticipated that the CRE market would remain strong and continue to expand, creating additional demand for office and industrial space. In addition, NBRS Financial's credit policies from 2007 to 2013 required the board of directors to approve the "accumulation of loans to a single borrower over $1.5 million." Over this same time period, the bank extended several loans that were subject to the credit policy requirement for single borrowers. The board of directors' approval of the CRE loans and large loans to single borrowers heightened the bank's concentration risk and resulted in violations of Maryland's legal lending limits.

In 2010 and 2011, NBRS Financial's board also approved questionable practices, including authorizing the President's entertainment-related corporate credit card transactions as well as awarding him a $20,000 bonus in violation of TARP standards.[9] In examination reports issued in January 2011 and July 2012, FRB Richmond examiners noted these actions as inappropriate practices. The board of directors maintained its approval of the entertainment-related expenses; however, it discontinued paying bonuses, in accordance with TARP standards. In addition, examiners noted in a 2012 examination that the board of directors approved an unsecured loan to the President, which the bank eventually charged off. Further, examiners downgraded loans extended to related interests of the President and a board member because the loans were

9. The U.S. Department of the Treasury's *TARP Standards for Compensation and Corporate Governance* prohibits an entity that received less than $25 million in TARP funds from paying a bonus to its most highly compensated employee.

"allegedly made under fraudulent terms and repayment remains questionable." The President and the board member resigned in early 2012.

From 2012 until March 2014, NBRS Financial's board was unable to hire a capable President. Following the President's resignation, the board of directors promoted a member of the bank's senior executive staff to acting President while allowing her to maintain her current role as CFO and Chief Operating Officer. In the May 2013 examination report, examiners noted this concentration of authority and stated that this was "not acceptable from a segregation of duties or control standpoint." In March 2014, FRB Richmond approved the appointment of a new President for NBRS—an individual who had served as a management consultant for the bank since 2013; however, the bank's deteriorating financial condition proved too difficult to overcome.[10] Overall, NBRS Financial's board did not provide effective oversight of the bank's strategic direction or ensure that the bank had the management team or the risk management practices and controls necessary to mitigate the deterioration in asset quality.

Significant Loan Portfolio Concentrations

From 2008 to 2012, FRB Richmond examiners identified loan portfolio concentrations in CRE and loans to individual borrowers, which present heightened risks to the institution. 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.[11] Given the slow recovery of the local economy, NBRS Financial's concentration risk in CRE loans and loans to individual borrowers contributed to the bank's weak financial condition.

CRE Concentrations Increased the Bank's Exposure to the Declining Economy

NBRS Financial's strategic plan predicted that BRAC would provide significant economic opportunities in commercial lending within the local economy. This strategy proved successful from 2005 to 2008, when the bank experienced a 53 percent growth in CRE lending. Within the CRE portfolio, the bank developed a significant concentration in construction, land, and land development (CLD) loans. CLD loan concentrations generally present heightened risk because developers' capacity to repay loans is contingent on whether they can obtain long-term financing or find a buyer for the completed project.

As shown in figure 1, NBRS Financial's CRE concentrations represented over 400 percent of total risk-based capital from 2006 to 2012 and exceeded peer averages.[12] The bank's CRE loans as a percentage of total risk-based capital exceeded both the supervisory criteria for concentration risk outlined in the Board's Supervision and Regulation Letter (SR Letter) 07-1, *Concentrations*

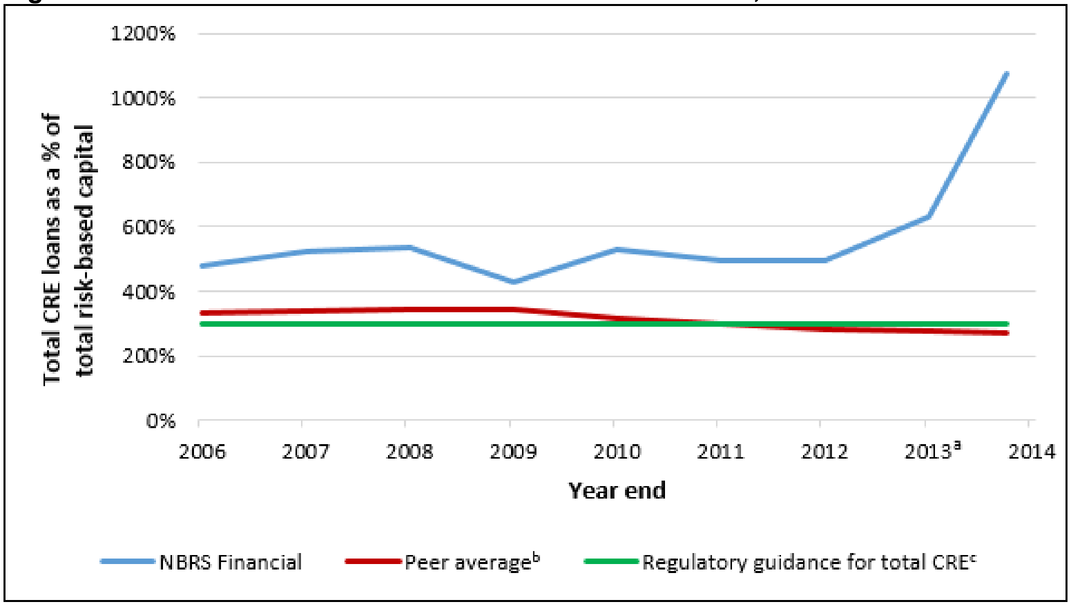
10. NBRS received an enforcement action in the form of a PCA directive in April 2014.

11. Office of Inspector General, *Summary Analysis of Failed Bank Reviews*, September 30, 2011.

12. NBRS Financial's peer group comprises insured commercial banks with (1) assets of $100 million to $300 million, (2) three or more full-service banking offices, and (3) location in a metropolitan statistical area.

in Commercial Real Estate Lending, Sound Risk Management Practices, and the levels of its peers.[13]

Figure 1: NBRS Financial's Total CRE Loan Concentrations, 2006–2014



Source: NBRS Financial, *Uniform Bank Performance Reports*, December 2006 through September 2014.

[a]The decline in NBRS Financial's capital from 2013 to the bank's failure in 2014 contributed to the increase in CRE loan concentrations.

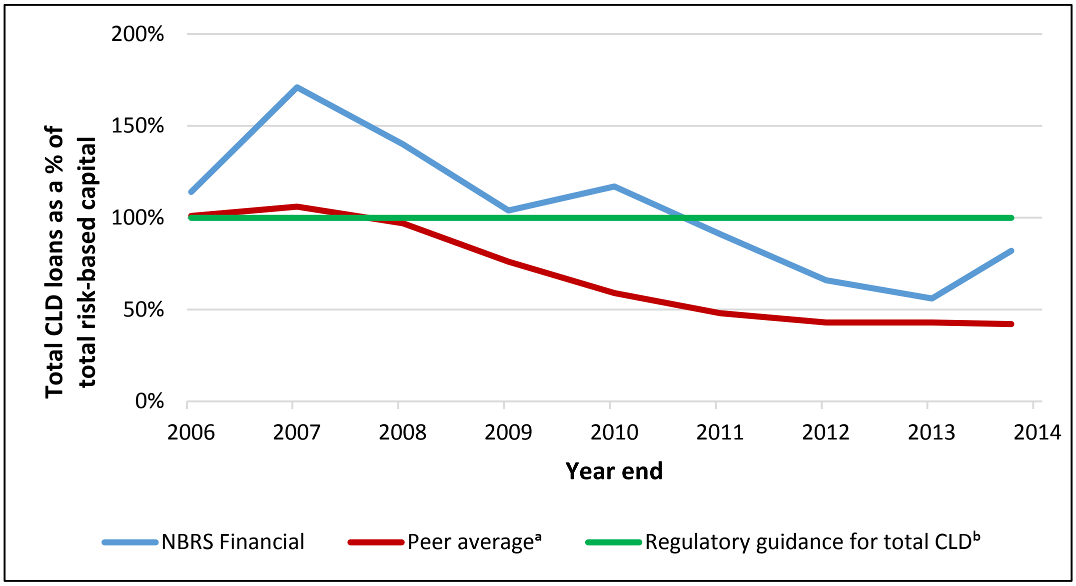
[b]NBRS Financial's peer group comprises insured commercial banks with (1) assets of $100 million to $300 million, (2) three or more full-service banking offices, and (3) location in a metropolitan statistical area.

[c]SR Letter 07-1 became effective in 2007; depiction of the CRE concentration guidelines prior to 2007 is for illustrative purposes only.

As a result of an examination that commenced in September 2009, in January 2010 NBRS Financial and its holding company entered into a written agreement with FRB Richmond and the State. In response to a provision of the written agreement, FRB Richmond and State examiners noted in a July 2010 examination report that NBRS Financial adopted limits for total CRE and CLD loans as a percentage of total capital. In addition, the bank made efforts to reduce concentrations, and FRB Richmond and State examiners noted in the January 2013 examination report NBRS Financial's progress in reducing its CLD loan concentrations through charge-offs and pay-downs in the commercial and industrial portfolio, as illustrated in figure 2. In that same examination report, FRB Richmond and State examiners noted that the economic downturn continued to delay recovery in Cecil County and the surrounding counties and stalled commercial and residential development projects. In addition, the sluggish real estate market continued to negatively affect borrowers' ability to pay their obligations.

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

Figure 2: NBRS Financial's Total CLD Loan Concentrations, 2006–2014



Source: NBRS Financial, *Uniform Bank Performance Reports*, December 2006 through September 2014.

[a]NBRS Financial's peer group comprises insured commercial banks with (1) assets of $100 million to $300 million, (2) three or more full-service banking offices, and (3) location in a metropolitan statistical area.

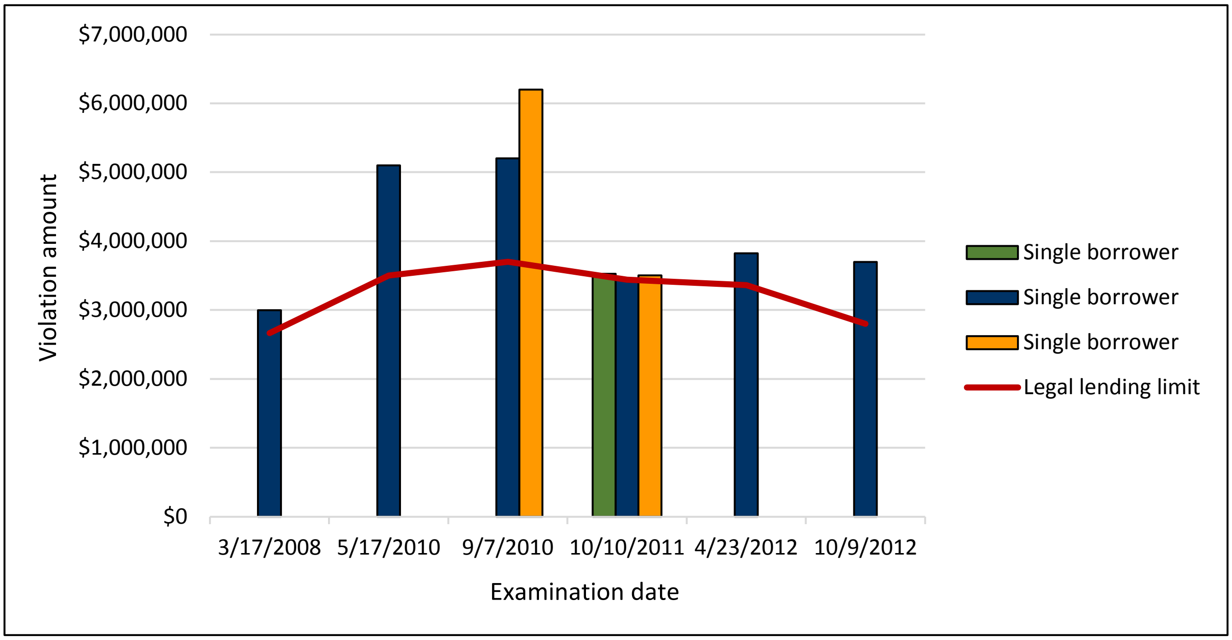
[b]SR Letter 07-1 became effective in 2007; depiction of the CLD concentration guidelines prior to 2007 is for illustrative purposes only.

Loans to Individual Borrowers Resulted in Violations of Legal Lending Limit

NBRS Financial also developed significant exposure to individual borrowers that led to violations of Maryland's legal lending limits.[14] FRB Richmond and the State identified that NBRS Financial had violated applicable limits in six examinations from 2008 to 2012, as noted in figure 3. Following the September 2010 examination, the State imposed a $10,000 civil money penalty for each of the two loans that exceeded the limits. FRB Richmond and State examiners noted that the NBRS Financial board's continued disregard for compliance with the applicable lending limits was "egregious" and indicative of "imprudent bank practices." The board of directors did little to correct these violations or mitigate the risks associated with these concentrations of credit.

14. The state of Maryland follows the legal lending limit for national banks that is set forth in 12 C.F.R. part 32—Lending Limits. Section 32.3(a) states, "A national bank's or savings association's total outstanding loans and extension of credit to one borrower may not exceed 15 percent of the bank's or savings association's capital and surplus, plus an additional 10 percent of the bank's or savings association's capital and surplus, if the amount that exceeds the bank's or savings association's 15 percent general limit is fully secured by readily marketable collateral."

Figure 3: NBRS Financial's Legal Lending Limit Violations, March 2008–October 2012



Source: FRB Richmond and State examination reports, 2008 to 2012.

Poor Credit Risk Management Practices

NBRS Financial's board and management failed to establish an adequate credit risk management program and credit administration commensurate with the risks in the bank's loan portfolio. According to the CBEM, the bank's board of directors and senior management have an important role in ensuring the adequate development, execution, maintenance, and compliance monitoring of the bank's internal controls. The CBEM notes that a component of internal control is risk assessment, which the manual defines as the identification, analysis, and management of risks. As early as 2009, FRB Richmond examiners noted inadequate credit administration, including inaccurate credit risk ratings and a lack of formal workout plans to address problem loans.[15] In 2009, examiners noted that the bank's overall credit risk management program was deficient and had not kept pace with the expansion of its loan portfolio and the increase in CRE exposure. Additionally, examiners noted in 2009 that the departure of the Chief Credit Officer and other loan staff members hampered the effectiveness of the credit risk management program.

The January 2010 written agreement that NBRS Financial and its bank holding company entered into with FRB Richmond and the State included provisions related to strengthening credit risk management practices, such as establishing appropriate risk tolerance guidelines and risk limits, revising risk limits to address changes in market conditions, and reducing the level of problem assets, among other things. From 2010 to 2012, FRB Richmond and State examiners noted that credit risk management processes and procedures had strengthened and that NBRS Financial had either partially, substantially, or fully complied with the credit risk management provision of the written agreement during this time frame. For example, FRB Richmond and State examiners noted in a January 2011 examination report that NBRS Financial had approved a credit risk

15. The CBEM states that "a loan workout can take many forms, including a modification that adversely affects the institution's real estate collateral protection after the modification, a renewal or extension of loan terms, the advancement of new monies, or a restructuring with or without concessions."

management plan that was enhanced to establish appropriate risk tolerance guidelines and had implemented procedures to review all criticized and classified loans on a quarterly basis. Despite improvements in credit risk management processes and procedures, NBRS Financial continued to struggle with applying accurate internal risk ratings, resulting in downgrades in loan relationships in 2011 and 2012. In a July 2012 examination report, FRB Richmond and State examiners noted numerous recurring credit risk management weaknesses, including poor underwriting, insufficient financial analysis, and the consummation of loans without obtaining or securing appropriate collateral. Examiners also noted only partial compliance with the written agreement due to the bank's inaccurate internal risk ratings. NBRS Financial's credit risk management weaknesses persisted and remained unresolved leading up to the bank's failure in 2014.

Ineffective Problem Loan Identification

NBRS Financial also struggled with identifying problem loans, which led to numerous examiner downgrades of the ratings assigned to lending relationships from 2009 to 2014. Examiners noted that downgrades were due to (1) inaccurate credit risk ratings, (2) slow recognition of problem loans, (3) inadequate workout practices, and (4) a weak internal grading system. In 2009, examiners noted that staff turnover in the lending function resulted in problem loan relationships not being identified in a timely manner. At this time, FRB Richmond and State examiners determined that the "future trend in asset quality is dependent on management's ability to stabilize the various problem loan relationships."

From 2009 to the bank's failure in 2014, NBRS Financial's management did not implement adequate credit risk management practices to effectively identify problem loans and establish formal workout plans for its problem loans. As a result, examiners continued to downgrade loan relationships, leading to sustained increases in the bank's adversely classified assets. As illustrated in table 1, NBRS Financial's adversely classified assets increased significantly from 2008 to 2012. By June 2010, adversely classified assets represented over 206 percent of tier 1 capital and allowance for loan and lease losses (ALLL), and by June 2014, adversely classified assets represented over 322 percent of tier 1 capital plus ALLL. During the examinations conducted in 2013 and 2014, FRB Richmond examiners noted that additional examiner downgrades of loan relationships contributed to the deterioration of NBRS Financial's capital.

Table 1: NBRS Financial's Adversely Classified Assets, September 2006–June 2014[a]

Adversely classified assets	Sep 06	Dec 07	Jul 09	Apr 10	Jun 10	Sep 11	Mar 12	Sep 12	Sep 13	Feb 14	Jun 14
In thousands of dollars	3,148	6,107	22,039	25,172	48,838	48,459	55,780	47,919	36,250	38,039	34,965
As % of tier 1 capital plus ALLL	20.20	34.35	90.50	105.60	206.50	216.80	289.70	272.20	272.30	311.33	322.38

Source: FRB Richmond and State examination reports, 2006 to 2014.

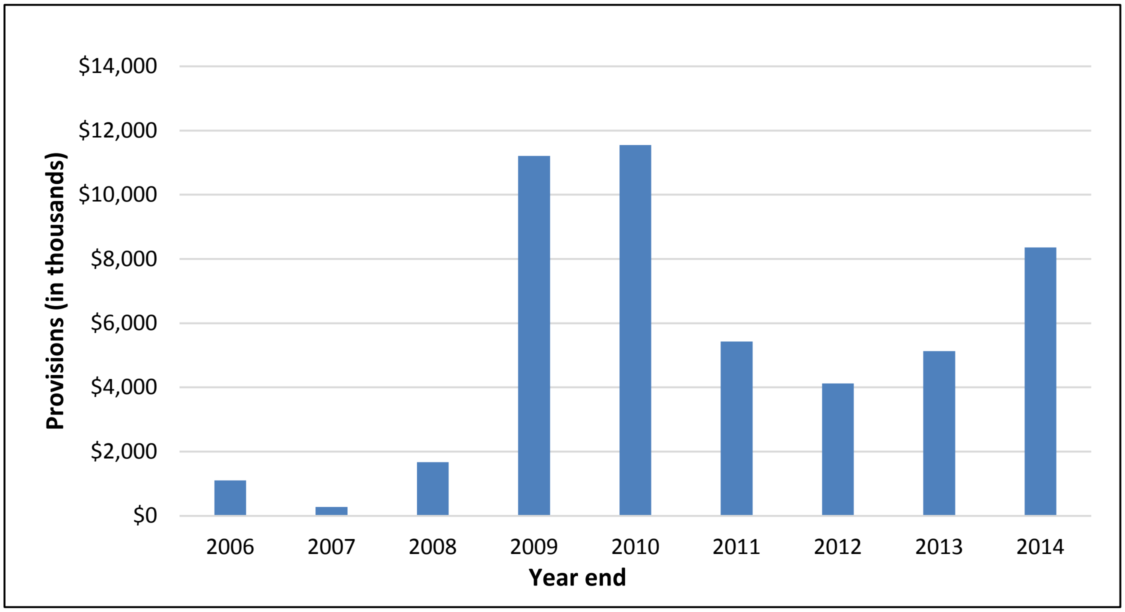
[a]This table includes only those reports in which adversely classified asset amounts were specifically noted by examiners.

Deficient ALLL Level and Methodology

As early as 2009, FRB Richmond examiners highlighted that NBRS Financial management had not established an adequate ALLL methodology, and examiners primarily attributed the ALLL deficiency to the bank's failure to assign proper loan risk ratings and identify impaired losses. The written agreement included a provision related to ALLL that required the bank to review and revise its ALLL methodology in a manner consistent with relevant supervisory guidance and findings and recommendations set forth in prior examinations. Subsequently, examiners noted improvements in the ALLL methodology in the July 2011 examination report, before noting deficiencies again from 2012 to 2014.

As early as 2009, FRB Richmond examiners noted deficiencies in NBRS Financial's ALLL levels. Due to the bank's reluctance to recognize problem loans and establish an adequate ALLL methodology, the corresponding allowance was not commensurate with the level of risk and deterioration of the loan portfolio. NBRS Financial incurred significant provision expenses to return the ALLL to satisfactory levels. In both 2009 and 2010, the bank's provision expenses to the ALLL exceeded $10 million, as shown in figure 4. Overall, from 2009 to 2014, NBRS Financial's management failed to adequately allocate reserves against potential losses.

Figure 4: NBRS Financial's Provisions to the ALLL, 2006–2014



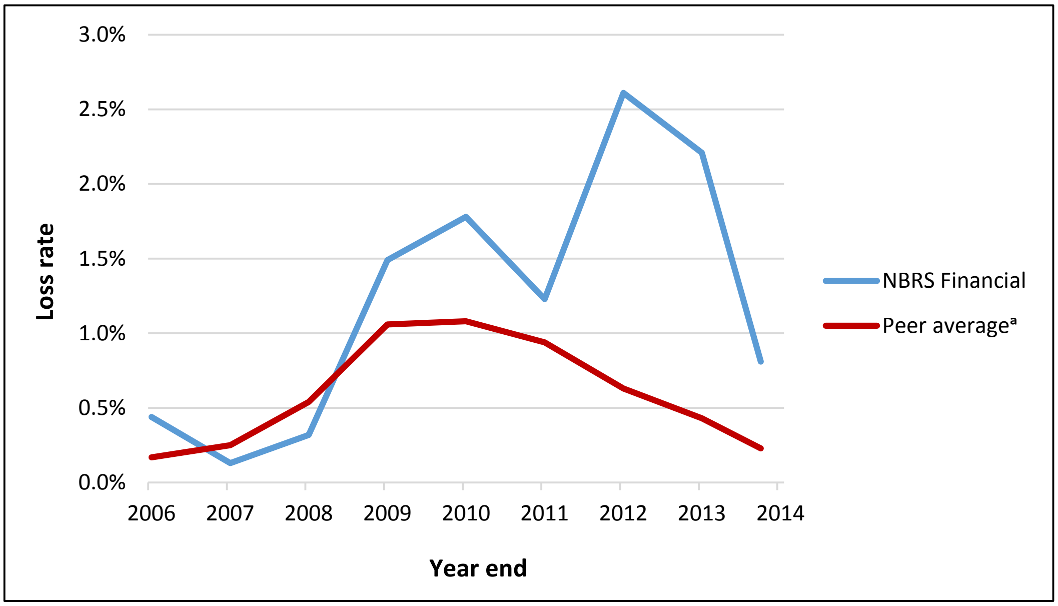
Source: NBRS Financial, *Uniform Bank Performance Reports*, December 2006 through September 2014.

Losses Resulting From Asset Quality Deterioration

NBRS Financial's failure resulted primarily from the bank's deteriorating asset quality and management's inability to reverse asset quality deterioration and curtail losses. FRB Richmond and State examiners noted that many factors contributed to the deterioration of NBRS Financial's asset quality. These factors included deficient credit administration, ineffective problem loan identification, deficient ALLL level and methodology, and downgrades in loan relationships and increased nonaccrual loans.

NBRS Financial's management could not overcome the losses from the rapid decline in asset quality. From 2009 to 2014, management actively reduced the bank's total assets to improve capital ratios; however, FRB Richmond and State examiners noted in a December 2013 examination report that revenue was not sufficient to support overhead expenses and provide meaningful net income as a means to supplement capital. NBRS Financial reported a loss in year-end earnings for each calendar year during the eight years prior to its failure. As illustrated in figure 5, the bank's loss rate exceeded its peers' averages from 2009 to the bank's failure.

Figure 5: NBRS Financial's Year-End Net Loss to Average Total Loan and Lease Versus Peers, 2006–2014



Source: NBRS Financial, *Uniform Bank Performance Reports*, December 2006 through September 2014.

[a]NBRS Financial's peer group comprises insured commercial banks with (1) assets of $100 million to $300 million, (2) three or more full-service banking offices, and (3) location in a metropolitan statistical area.

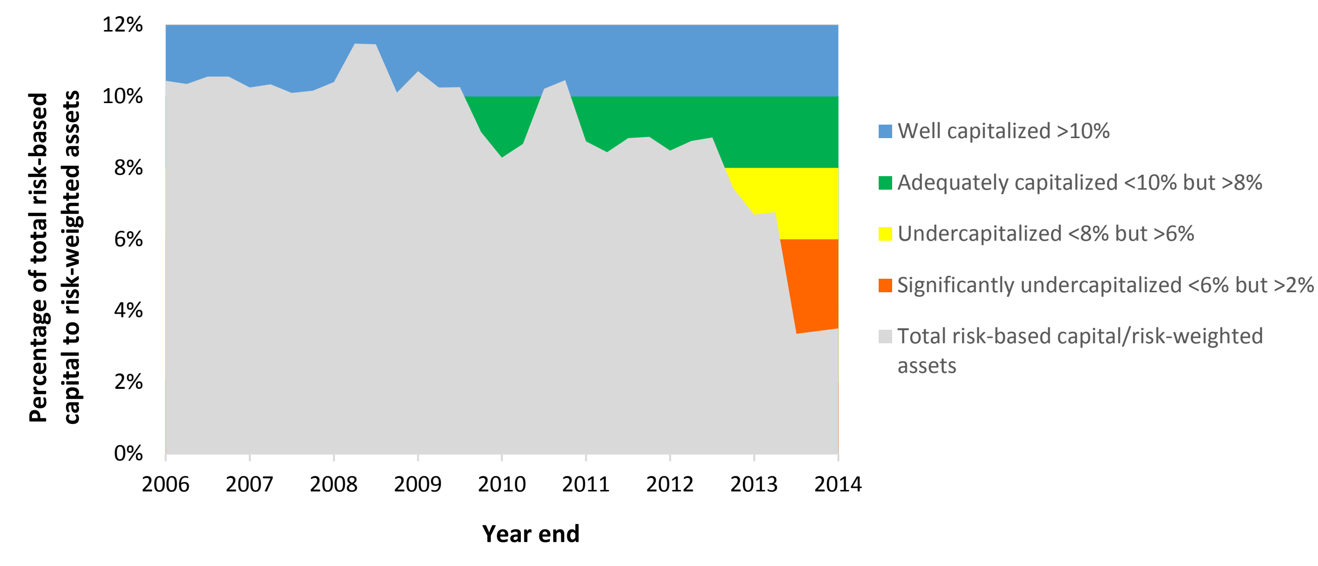
Gradual Erosion of Capital

NBRS Financial's asset quality deterioration resulted in net losses and depleted capital. As early as 2008, FRB Richmond examiners noted that the primary strategy of NBRS Financial's management was to maintain capital using available resources from the bank holding company, Rising Sun Bancorp. Subsequently, in 2009, NBRS Financial received approximately $6 million in TARP funding transferred from the holding company.[16] Despite the additional capital, examiners repeatedly criticized the bank's capital levels from 2009 to its failure in 2014. In the September 2010 examination, examiners stated that "capital levels are critically deficient in relation to the risk profile of the bank." Asset quality deterioration, including the large provision

16. NBRS Financial qualified for TARP funding because it received a CAMELS composite 2 rating prior to the bank's application for funding in November 2008. See appendix B for more information about the CAMELS rating system.

expenses, continued to result in net losses and depleted capital. As illustrated in figure 6, NBRS Financial's capital position fell below *well capitalized* PCA status in 2010.[17] Although the January 2010 written agreement required NBRS Financial to submit an acceptable capital plan, the bank failed to develop a sufficient capital improvement plan.

Figure 6: NBRS Financial's PCA Capital Designations, 2006–2014[a]



Source: NBRS Financial, *Uniform Bank Performance Reports*, December 2006 through September 2014.

[a]For our analysis of NBRS Financial's PCA designations, we used the total risk-based capital to risk-weighted assets ratio. In addition, data for 2014 are as of September 30, 2014, because NBRS Financial failed on October 17, 2014.

NBRS Financial returned to a *well capitalized* PCA status following a $2 million capital injection in June 2011. The bank also closed three branches in 2011 and 2012 to reduce the size of the balance sheet and lower expenses. However, in 2012, as a result of additional downgrades in loan relationships, NBRS Financial's capital position again fell below *well capitalized* status, declined to *undercapitalized* status in September 2013, and became *significantly undercapitalized* in June 2014.

As a result of NBRS Financial's capital erosion, declining PCA status, and failure to file an acceptable capital restoration plan, the Board issued a PCA directive effective April 7, 2014. The PCA directive afforded NBRS Financial 60 days to (1) increase the bank's equity through the sale of shares or contributions to surplus in an amount sufficient to make the bank adequately capitalized, (2) enter into and close a contract to be acquired by a depository institution or holding company, or (3) take other necessary measures to make the bank adequately capitalized. NBRS

17. Per the CBEM, PCA uses the total risk-based capital, tier 1 risk-based capital, and tangible equity ratio to assign 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 capital ratio is less than 8 percent, the tier 1 risk-based capital 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 significant growth.

Financial did not comply with the PCA directive and fell to *critically undercapitalized* as a result of an examination that began in August 2014.[18] As a result, the State appointed the FDIC as receiver.

18. The CBEM defines *critically undercapitalized* as a bank with a ratio of tangible equity to total assets that is equal to or less than 2 percent.

Supervision of NBRS Financial

FRB Richmond complied with the examination frequency guidelines contained in CBEM section 1000.1 for the time period we reviewed, 2006 through 2014, and conducted regular offsite monitoring. During this time period, FRB Richmond and the State conducted seven full-scope examinations and six target examinations. Supervisory activity during 2006 through 2014 resulted in a memorandum of understanding (MOU), a written agreement, and a PCA directive. FRB Richmond also implemented applicable PCA provisions. As shown in table 2, NBRS Financial's CAMELS composite rating declined from a 2 in 2008 to a 4 in 2009, and the bank remained a 5-rated institution from 2011 until it failed in 2014.

Table 2: Supervisory Overview of NBRS Financial, 2006–2014

Examination				CAMELS composite rating	CAMELS component and risk management ratings							Supervisory actions
Start date	Report issue date	Scope	Agency conducting examination		Capital	Asset quality	Management	Earnings	Liquidity	Sensitivity	Risk management	
10/23/2006	12/28/2006	Full	FRB Richmond	2	2	2	2	2	2	2	3	MOU effective 10/23/2006
03/17/2008	06/20/2008	Full	State	2	2	2	2	2	2	2	2	
09/07/2009	12/17/2009	Full	FRB Richmond	4	4	4	4	5	3	2	4	Written agreement effective 01/28/2010
05/17/2010	07/26/2010	Target	FRB Richmond (joint)	4	4	4	4	5	3	2	4	
09/07/2010	01/06/2011	Full	State (joint)	5	5	5	5	5	4	3	5	
04/25/2011	07/20/2011	Target	FRB Richmond (joint)	5	5	5	5	5	4	3	5	
10/10/2011	01/13/2012	Full	FRB Richmond (joint)	5	5	5	5	5	3	3	5	
04/23/2012	07/13/2012	Target	FRB Richmond (joint)	5	5	5	5	5	3	3	5	
10/09/2012	01/15/2013	Full	State (joint)	5	5	5	5	5	4	3	5	
04/08/2013	05/23/2013	Target	FRB Richmond (joint)	5	5	5	5	5	4	4	5	
10/15/2013	12/16/2013	Full	FRB Richmond (joint)	5	5	5	5	5	5	5	5	
04/07/2014	05/21/2014	Target	FRB Richmond (joint)	5	5	5	5	5	5	5	5	PCA directive issued 04/07/2014
08/04/2014	10/01/2014	Target	FRB Richmond (joint)	5	5	5	5	5	5	5	5	

Source: NBRS Financial examination reports, 2006 through 2014.

In our *Summary Analysis of Failed Bank Reviews* report, we noted that the need for stronger supervisory action was a recurring theme in our prior failed bank reviews. For the failure of NBRS Financial, however, our analysis resulted in a different conclusion. Our review of FRB Richmond's supervision of NBRS Financial from 2006 to 2014 revealed that FRB Richmond frequently took decisive actions at its earliest opportunity to do so. For example, FRB Richmond took strong supervisory action in response to the numerous weaknesses and deficiencies detected during an examination that concluded in December 2009 by issuing a CAMELS composite rating double downgrade and multiple component rating downgrades, as well as implementing a formal enforcement action in the form of a written agreement. In response to findings noted during the examination that concluded in July 2012, FRB Richmond also recommended that the Board pursue a prohibition order against the President of NBRS Financial upon detecting the alleged insider abuse. We believe that FRB Richmond seized opportunities to take strong supervisory action and recommended decisive actions, such as a prohibition order and a cease-and-desist order. Although the Board did not pursue the recommended actions, we did not identify any opportunity for FRB Richmond to take a more decisive supervisory action in supervising this institution.[19]

Satisfactory Rating From 2006 to 2008

As a result of joint examinations in 2006 and 2008, NBRS Financial received a CAMELS composite 2 rating. In a December 2006 examination report, FRB Richmond examiners noted Bank Secrecy Act program deficiencies and rated the risk management program as less than satisfactory. Consequently, FRB Richmond and the State entered into an MOU with NBRS Financial related to the Bank Secrecy Act deficiencies cited in the examination report. Aside from the Bank Secrecy Act issues, examiners rated individual CAMELS components as *satisfactory*, in large part because of NBRS Financial's "sound strategic plan" and the slowing of the bank's loan production in light of the softness in the local real estate market. Management also tightened underwriting standards to reduce loan growth.

Subsequently, in the 2008 State-led examination, examiners noted that NBRS Financial experienced a 53 percent increase in CRE lending. This type of loan portfolio growth could signal a potential increase in concentration risk. During this time, however, NBRS Financial's capital position exceeded *well capitalized* requirements. In addition, the bank's earnings performance augmented the bank's capital. Therefore, the State maintained the bank's CAMELS composite 2 rating during the 2008 examination.

During the State's 2008 examination, the MOU with NBRS Financial related to the Bank Secrecy Act program deficiencies remained in effect, but examiners noted partial and full compliance with individual provisions of that enforcement action. Examiners preserved the prior satisfactory composite ratings and most of the component ratings except for risk management, which improved from 3 to 2.[20] While State examiners identified a legal lending limit violation during this examination, the bank took immediate action to address the violation. From 2006 to 2008, we did not note any opportunities for FRB Richmond to take any alternative supervisory actions.

19. According to a Board official, the Board typically does not pursue prohibition orders while investigative activities remain open.

20. NBRS Financial fully complied with the MOU in February 2009.

2009 Examination Resulted in Significant Downgrades and Formal Enforcement Action

In its December 2009 examination report, FRB Richmond took decisive supervisory action by downgrading NBRS Financial from a CAMELS composite 2 to a 4. As shown in table 2, examiners also downgraded the bank's capital, asset quality, management, and risk management component ratings from 2 to 4 and triple-downgraded the bank's earnings component from 2 to 5. Examiners noted that third quarter provision expenses resulted in a net loss of $3.8 million. Provision expenses for the quarter totaled $4.1 million, compared with only $830,000 for the first half of the year. Examiners noted that these provisions were necessary because of significant turnover in lending staff, which delayed problem loan recognition. As illustrated in table 1, the bank's adversely classified assets increased dramatically, from approximately $6 million during the prior 2008 examination to over $22 million. As a result of the findings noted during this examination, FRB Richmond implemented a formal enforcement action in the form of a written agreement that became effective on January 28, 2010.

January 2010 Written Agreement

The written agreement contained 17 provisions that highlighted areas that ultimately contributed to the bank's failure, including board of directors oversight, management, credit risk management, concentrations of credit, asset improvement, ALLL, and the bank's capital and earnings positions. Following the September 2010 examination, FRB Richmond and State examiners again took decisive action by downgrading the bank to a CAMELS composite 5. Examiners noted that the bank's condition deteriorated further to critically deficient. Specifically, asset quality, management, earnings, and capital were noted as areas that experienced substantial decline. FRB Richmond maintained the written agreement and monitored each provision for compliance at each examination from 2010 until the bank's failure. The bank remained unable to comply with all the provisions of the written agreement prior to failing.

Request for Stronger Supervisory Action

On May 8, 2012, FRB Richmond again took decisive supervisory action with respect to NBRS Financial by recommending that the Board (1) formally investigate NBRS Financial, (2) initiate a prohibition order against the President and an NBRS Financial board member, and (3) issue a temporary cease-and-desist order to prevent the President and the board member from certain actions related to the bank's upcoming shareholder meeting. Due to an open federal law enforcement investigation and the resignation of the President and relevant board member in February 2012, the Board did not proceed with the actions requested by FRB Richmond.

Conclusion

From 2009 to 2014, FRB Richmond took decisive supervisory actions to address NBRS Financial's weaknesses and deficiencies. Beginning in 2009, these actions included significant CAMELS composite and component downgrades. Further, FRB Richmond and the State increased the examination cycle to two examinations per year, which occurred from 2010 until the bank's failure. Also in 2010, FRB Richmond implemented a written agreement that identified the significant issues that contributed to the bank's failure. FRB Richmond examiners monitored NBRS Financial's attempted compliance with all provisions of the written agreement, but the bank was unable to fully comply with the written agreement prior to the bank failing. In 2012, NBRS Financial's board of directors asked the President and a board member to resign for not disclosing their related interests in several loans. Shortly after, as we described above, FRB Richmond recommended enforcement actions against the relevant institution-affiliated parties.[21] At this point, the bank's financial condition was critically deficient and the leadership vacancy left the bank in a position that was difficult to overcome. Based on our analysis of FRB Richmond's supervision, we found that the Reserve Bank took appropriate and decisive supervisory action.

21. The CBEM defines an *institution-affiliated party* as an individual associated with institutions and "includes any officer, director, employee, controlling shareholder, or agent of a financial institution, and any other person who has filed or is required to file a change-in-control notice. It also includes any shareholder, consultant, joint-venture partner, or any other person who participates in the conduct of the affairs of the financial institution any other person who participates in the conduct of the affairs of the financial institution as well as any independent contractors, including attorneys, appraisers, and accountants, who knowingly or recklessly participate in any violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, a financial institution."

Finding: The Board Should Expand Examiner Guidance or Training on Dominant Management and Associated Risks

We concluded that NBRS Financial's President was a dominant management official who was heavily involved in the bank's daily operations and surrounded himself with inexperienced senior executive staff. These circumstances, along with the bank's internal control weaknesses, segregation of duties issues, and inadequate credit risk management practices, created an opportunity for the President to allegedly engage in insider abuse. We attempted to identify existing Board supervisory guidance for examiners outlining how examiners should assess and respond to the presence of a dominant management official. However, we found that such guidance does not exist. In our review of prior failures, we noted that recurring factors appeared to exist when dominant management officials engaged in insider abuse. These additional factors include key control functions that have been undermined or rendered ineffective, and pervasive internal control weaknesses. We believe that the recurring nature of this fact pattern warrants guidance or training for examiners that outlines how to address these conditions as decisively and expeditiously as possible. Such guidance or training may help mitigate internal abuse and fraud risk at an institution by identifying weaknesses and conditions that create the opportunity for insider abuse or fraud.

Dominant Management Official Heightening Internal Abuse and Fraud Risk Is a Recurring Theme in the OIG's Prior Failed Bank Reviews

One of the most significant factors in the failure of NBRS Financial was the President's dominant influence on the bank's operations, which limited the institution's ability to overcome its deteriorating financial condition. In examination reports from 2009 to 2012, examiners repeatedly noted the President's dominant role over the bank's operating policies, procedures, and overall financial condition. Under the President's leadership, NBRS Financial experienced significant corporate governance weaknesses and ineffective key internal control functions. In our opinion, the President's dominance over many aspects of the bank's daily operations created the opportunity for the alleged insider abuse.[22]

Prior to this in-depth review, our office conducted three failed bank reviews that involved dominant management officials and instances of alleged insider abuse. These reviews evidenced common fact patterns and themes that overlap with the NBRS Financial failure.

- **The Bank of the Commonwealth (supervised by FRB Richmond)**—Closed on September 23, 2011, with an estimated loss of $268 million to the DIF. The President was a dominant and controlling figure at the institution. He exceeded limits on his lending authority for two loan customers. Examiners highlighted that the bank's employees were reluctant to discuss problems with the President. Our report states that internal control issues and operational weaknesses remained unresolved at the bank because of management's reluctance to discuss such issues with the President. In our

22. In February 2012, NBRS Financial's board of directors asked the President and a board member to resign for not disclosing their related interests in several loans.

opinion, the bank's internal control weaknesses, including violations of segregation of duties principles, increased its risk profile by presenting the opportunity for key employees to engage in unsafe and unsound practices.

As a result of our joint investigation with other federal agencies, the former Chief Executive Officer and Chairman of the board of directors was convicted and sentenced to 23 years in prison, followed by 5 years of supervised release for conspiracy to commit bank fraud, false entry in a bank record, unlawful participation in loans, false statements to a financial institution, misapplication of bank funds, and bank fraud. The court also issued a restitution order that required the President to pay approximately $334 million in restitution to the FDIC. In addition, the court sentenced the former Vice President and Senior Commercial Loan Officer to 17 years in prison for conspiracy to commit bank fraud, false entries in bank records, misapplication of bank funds, and making a false statement to a financial institution. This individual received a restitution order similar to that of the President and forfeited $62 million in proceeds resulting from the criminal activities.

- **Pierce Commercial Bank (supervised by the Federal Reserve Bank of San Francisco)—**Closed on November 5, 2010, with an estimated loss of $25 million to the DIF. The board of directors and senior management allowed the mortgage banking division to operate independently, without appropriate oversight, and failed to conduct adequate strategic planning or implement robust internal controls. In our opinion, the significant autonomy afforded to the leaders of this division helped to create the opportunity for fraud. Examiners ultimately uncovered fraudulent activity in this division related to employees misrepresenting borrower financial information and steering customers into loans for which they were not qualified. These practices led to bank losses as a result of significant investor repurchase and indemnification demands.

  The former Senior Vice President and Loan Officer responsible for Pierce's mortgage banking division was convicted and sentenced to 10 years in prison and 5 years of supervised release for conspiracy to make false statements in loan applications and for making false statements to the U.S. Department of Housing and Urban Development.

- **Orion Bank (supervised by the Federal Reserve Bank of Atlanta)—**Closed on November 13, 2009, with an estimated loss of $594 million to the DIF. The President had a dominant role in the bank and held a controlling interest in the parent bank holding company. The President was noted as dominant in establishing the bank's strategic direction and overall risk profile and in its day-to-day management. As a result of our joint investigation with other federal agencies, the President was sentenced to 6 years in prison for conspiring to commit bank fraud, misapplying bank funds, making false entries in the bank's books and records, and obstructing a bank examination.

We found that the CBEM provides limited guidance on supervising banks with dominant management officials. The manual states that "the examiner should be alert for situations in which top management dominates the board or where top management acts solely at the direction of either the board or a dominant influence on the board."

Given the similarities between these prior material loss and in-depth reviews and the circumstances of NBRS Financial's failure, the Board's Division of Banking Supervision and

Regulation has the opportunity to highlight potential indicators of internal abuse or heightened fraud risk in situations involving dominant officials. This guidance or training may help to mitigate fraud risk by alerting examiners to potential red flags that could help them focus on addressing the weaknesses and conditions that create the opportunity for insider abuse or fraud.

Recommendation

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

1. Develop supervision guidance or training to help Reserve Banks

    a. identify the circumstances in which the presence of dominant bank officials may heighten the risk of fraud or insider abuse. Based on our failed bank reviews, we believe these circumstances include, but are not limited to,

        - weak internal control functions
        - ineffective governance and oversight
        - frequent turnover of senior management officials
        - significant internal control weaknesses, including segregation of duties issues

    b. take appropriate actions to address these conditions.

Management's Response

The Director of the Division of Banking Supervision and Regulation concurred with our recommendation. In his response, he indicates that Division of Banking Supervision and Regulation staff will develop examiner training to help Reserve Banks identify circumstances in which the presence of dominant bank officers heightens the risk of fraud or insider abuse and to highlight appropriate actions that should be taken to address those conditions.

OIG Comment

The actions described by the Director of the Division 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.

Appendix A
Glossary of Banking and Regulatory Terms

Adversely 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.

Allowance for Loan and Lease Losses (ALLL)

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

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

Cease-and-Desist Order

A formal supervisory enforcement action against a financial institution or an institution-affiliated party that violates a law, rule, regulation, written commitment, or written agreement, or that is engaged in unsafe or unsound business practice. The order may require a financial institution or institution-affiliated party to (1) stop engaging in specific practices or violations or (2) take action to correct any resulting conditions. The provisions of a cease-and-desist order and the problems identified at the institution are more severe than those of a written agreement, which is the least severe type of formal supervisory enforcement action.

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.

Construction, Land, and Land Development (CLD) Loans

A subset of commercial real estate loans, secured by real estate (including nonagricultural vacant land), for (1) onsite construction of industrial, commercial, residential, or farm buildings and (2) land development, including preconstruction preparatory work such as laying sewer and water pipes.

Enforcement Actions

The Board has a broad range of enforcement powers that includes formal and 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 MOUs.

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

Prohibition Order

The Board is authorized to remove any institution-affiliated party as a result of certain violations or misconduct and to prohibit the party from participating in the affairs of any financial institution or its subsidiaries in the future. This would include prohibition from acting as an institution-affiliated party or from voting on any manner regarding the institution.

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 to 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 Letter (SR Letter)

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 distributed 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 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 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.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: March 25, 2016

To: Melissa Heist
Associate Inspector General

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

Subject: Review of the Failure of NBRS Financial

The staff of the Division of Banking Supervision and Regulation (BS&R) has reviewed the draft Review of the Failure of NBRS Financial (NBRS), Rising Sun, Maryland, prepared by the Office of Inspector General (OIG). The report finds that NBRS failed to a large extent because the bank consolidated authority in a high level official whose dominant influence over bank operations inhibited the bank's recovery. Moreover, this official engaged in improper business practices for his own benefit. NBRS 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 examination frequency guidelines and implemented appropriate corrective actions. However, the report recommends that BS&R develop supervision guidance or training to highlight potential indicators of internal abuse and fraud risk involving dominant officials.

BS&R staff acknowledge the conclusion in the report. The NBRS failure exemplifies the risk of loss associated with dominant senior bank officials that have interests in conflict with the safety and soundness of insured depository institutions. It further illustrates the need for strong supervisory action where board of directors are ineffective in their oversight and where the business of a bank is driven by dominant senior officials having inherent conflicts of interests that may lead to fraud or insider abuses.

In response to the report recommendation, BS&R staff will develop examiner training to help Reserve Banks identify circumstances where the presence of dominant bank officers heighten the risk of fraud or insider abuse and to highlight appropriate actions that should be taken to address those conditions.

Office of Inspector General
Board of Governors of the Federal Reserve System
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OIGHotline@frb.gov

Report Fraud, Waste, and Abuse

Those suspecting possible wrongdoing may contact the OIG Hotline by mail, e-mail, fax, or telephone.

Office of Inspector General, c/o Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW, Mail Stop K-300, Washington, DC 20551
Attention: OIG Hotline

Fax: 202-973-5044

Questions about what to report?

Visit the OIG website at www.federalreserve.gov/oig
or
www.consumerfinance.gov/oig