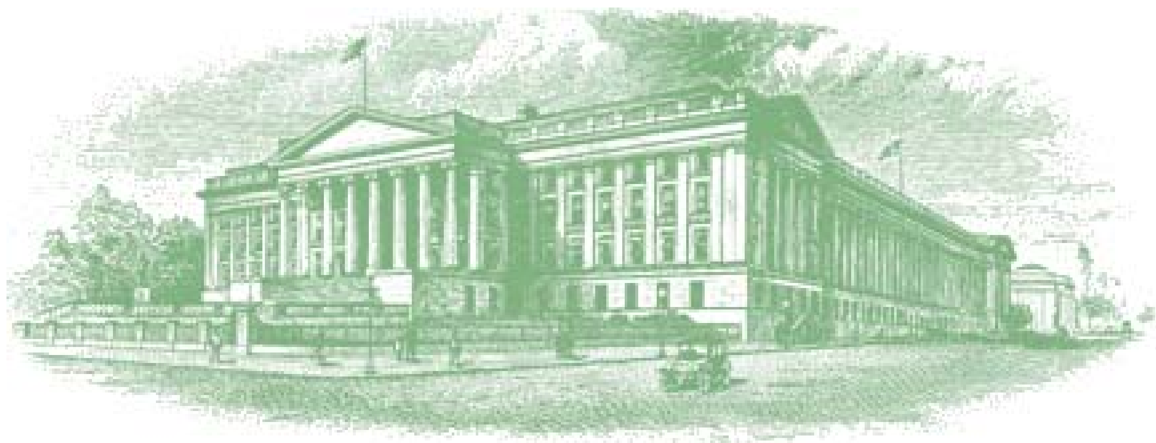
Audit Report



Report Number: OIG-SBLF-12-004

SMALL BUSINESS LENDING FUND: Soundness of Investment Decisions Regarding Later-Entry, Withdrawn and Reconsidered Institutions in the SBLF Program

July 3, 2012

Office of Inspector General

Department of the Treasury

Contents

Abbreviations

ARC	Application Review Committee
FBA	Federal Banking Agency
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
IC	Investment Committee
OIG	Office of Inspector General
OCC	Office of the Comptroller of the Currency
SBLF	Small Business Lending Fund

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OIG

Audit Report

The Department of the Treasury
Office of Inspector General

July 3, 2012

Don Graves, Jr.
Deputy Assistant Secretary for Small Business, Housing, and Community Development

This report presents the results of our audit of investment decisions involving the Small Business Lending Fund (SBLF). SBLF is a fund created to provide capital to community banks with assets of less than $10 billion with incentives to stimulate small business lending. Our audit objectives were to determine whether Treasury: (1) consistently approved institutions that were financially viable and able to repay the SBLF investments; (2) gave adequate consideration to institutions that were not approved and asked to withdraw their applications; and (3) had adequate bases for denying funding to institutions.

To accomplish our first objective, we reviewed investment decision records for 47 randomly sampled institutions that Treasury approved and funded within the last 60 days preceding the program's September 27, 2011, funding deadline. We compared supervisory consultative memoranda from the institutions' regulators—the Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC)—to the most relevant bank examination reports prepared by FDIC and OCC to determine whether they provided Treasury with robust and complete information regarding the financial health of the institutions. We also attempted to review a sample of institutions regulated by the Federal Reserve Board (FRB), but the FRB declined to provide us with reports of examination until after our audit was completed, creating a scope limitation for the first objective of this audit.

To accomplish our second objective, we reviewed documents supporting Treasury's investment decisions for a judgmental sample of 34 institutions that Treasury identified as being "reconsidered" for SBLF funding. We also reviewed updated financial and regulatory information recorded by Treasury subsequent to its initial review of the reconsidered institutions, and verified that Treasury was not informed of changes that had occurred in the financial condition of institutions that were not reconsidered. We interviewed SBLF staff, and officials from FDIC, and OCC. Finally, to accomplish our third objective, we reviewed investment decisions for a sample of 51 institutions that Treasury asked to withdraw from the program between June and September 2011.

We conducted our fieldwork from October 2011 to May 2012 in accordance with *Government Auditing Standards*. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. Accordingly, we believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Appendix 1 contains a more detailed description of our audit objectives, scope, and methodology.

Results in Brief

Based on our review of 47 FDIC- and OCC-regulated banks, we found that Treasury consistently approved institutions that would likely meet their financial obligations to the SBLF program. However, we identified four institutions that had repayment probabilities below the 80-percent threshold for program acceptance. For three of the institutions Treasury documented compensating factors supporting its funding decisions. However, Treasury did not have an adequate basis for elevating the repayment probability of the fourth institution. Similar to our previous audit, bank examination reports from the Federal Banking Agencies (FBAs) for these institutions flagged supervisory concerns beyond those disclosed to Treasury in supervisory consultative memoranda. Treasury was aware of these concerns for all but one of the admitted institutions, primarily because Treasury's documentation of its decisions improved.

We also found that institutions not admitted into the program received adequate consideration before Treasury asked them to withdraw their applications. In all 34 cases reviewed, Treasury requested updated supervisory information, financial data, and/or the status of regulator-imposed dividend restrictions before deciding to approve or deny the applications. The applicants also received reconsideration based on consistent criteria.

Finally, our review of 51 institutions denied funding disclosed that 32 did not meet the basic eligibility requirements, and therefore could not be admitted. The remaining 19 institutions were reviewed by Treasury's Application Review Committee (ARC) or Investment Committee (IC) and denied funding based on clear risks the committees identified with the financial health of the banks and/or their lending practices.

Background

On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010, establishing the SBLF. SBLF is a fund created to provide capital to community banks with incentives to stimulate small business lending and, as a result, promote job creation and economic growth within communities. In addition to statutory eligibility requirements, participation in the SBLF program was restricted to financially viable institutions that were (1) adequately capitalized, (2) not expected to become undercapitalized, and (3) not expected to be placed into conservatorship or receivership.

Treasury launched the SBLF program in December 20, 2010, and by the June 22, 2011 application deadline, had received requests from 935 financial institutions for $11.8 billion of the $30 billion authorized for the program. Treasury disbursed approximately $2.3 billion of the funds in the last 60 days leading up to the September 2011 deadline. By the program's September 27, 2011 funding deadline, Treasury issued preliminary approvals to 400 institutions, with 332 institutions accepting a total of $4.03 billion. Of the remaining 535 applicants, 461 were not admitted, and 74 withdrew prior to Treasury's consideration.

In May 2011, we reported that Treasury established an 8-step investment decision process that examined applicant eligibility, financial viability, and ability to repay Treasury's SBLF investment.[1] While we determined that the process was consistent with legislative eligibility requirements, we also identified areas for improvement. Specifically, we reported that Treasury did not require thorough disclosure from the FBAs of supervisory issues influencing the health of the banks and had granted FBAs significant discretion over the types of information they could report to Treasury. However, Treasury personnel did not agree to specify the types of supervisory issues that FBAs should report, because doing so would have reopened what had already been lengthy negotiations with the regulators.

In February 2012, we reviewed 23 of the first 55 applicants accepted into the SBLF program.[2] We reported that Treasury approved institutions that may have difficulty meeting repayment and dividend obligations partly because it did not obtain sufficiently robust information from federal regulators about the condition of the institutions applying for

[1] OIG-SBLF-11-001, *Small Business Lending Fund: Investment Decision Process for the Small Business Lending Fund*, May 13, 2011.
[2] OIG-SBLF-12-002, *Small Business Lending Fund: Soundness of Investment Decisions Regarding Early-Entry Applicants into the SBLF Program*, February 17, 2012.

funding. However, Treasury also admitted institutions despite supervisory issues and investment staff concerns about applicant repayment ability. This occurred because Treasury gave federal regulators discretion over what information they reported, did not document their consideration of the supervisory concerns provided, and overrode requirements during the application review process.

Treasury Generally Approved Institutions that Could Likely Meet Their Financial Obligations to the SBLF Program

Our review of supervisory and financial information for 47 FDIC- and OCC-regulated institutions admitted to the SBLF program disclosed that they were generally viable and likely to meet dividend and repayment obligations. However, we identified four institutions that were admitted to the program with repayment probabilities of less than 80 percent—the program threshold for acceptance. Treasury adequately supported its approval of three of these institutions by compensating factors justifying the investment decisions, but did not adequately support its approval of the fourth institution. We also found that Treasury had sufficiently robust information from the FBAs about the financial health of the institutions and that it performed a thorough analysis of those admitted.

Treasury Admitted Some Institutions with Potential Repayment Issues

We identified four institutions, including one TARP recipient, that were accepted into SBLF with repayment probabilities below the threshold set for the program. Treasury established an 80-percent repayment probability threshold for participation. Despite this threshold, it approved one institution whose repayment probabilities were 70 percent and three that were 76 percent. For three of the institutions, including the one TARP recipient, Treasury documented in ARC or IC minutes the reasons for revising the credit analyst's assessment including:

- The first institution's classified assets were $6 million or 40 percent lower than the additional loan losses projected by the credit analyst, resulting in an improved forward Tier 1 ratio and a revised repayment probability above 80 percent;

- The second institution's earnings were projected to be $2 million more than the credit analyst's projection, based on current earnings. The higher projected earnings would improve the institution's Tier 1 capital ratio, resulting in a revised repayment probability of 80 percent;

- The credit analyst's projected loan losses of $37 million were approximately 30 percent higher than the third institution's classified assets of $24 million. In addition, the ARC noted that the institution had no other debt, its allowance for loan and lease losses was adequately funded, and the quality of the institution's assets had improved.

In each case, Treasury documented its deliberations and the factors that led to its repayment recalculations in the minutes associated with the institutions. Although we do not know whether these institutions will be able to pay dividends and repay the SBLF investments, Treasury's analyses are transparent in the minutes.

However, Treasury did not appear to have an adequate basis for raising one de novo institution's repayment probability level. Because this institution had no classified assets, Treasury reduced the classified assets and provisioning below those used in the credit analysis. Treasury also determined that, based on supervisory information, the credit analyst's evaluation of the institution's qualitative factors was overly negative. If adjusted for these factors, Treasury determined the loan losses would result in a Tier 1 common ratio of 8 percent and a repayment probability above 80 percent. Because this institution was a de novo bank, for which asset quality typically starts high until the portfolio matures and experiences more defaults, we believe Treasury should not have adjusted the institution's projected potential loan losses and forward Tier 1 common ratio based on the absence of classified assets.

Treasury Admitted Banks with Identified Issues with Asset Quality, Earnings, Capital, and Management

We found that 35 of the 47 approved institutions sampled had noted supervisory concerns. FDIC and OCC bank examination reports and supervisory consultative memoranda, CAMELS[3] ratings, and/or communications with Treasury mentioned concerns about these institutions' earnings, asset quality, capital, and/or bank management.

[3] "CAMELS" refers to ratings of six essential components of an institution's financial condition and operations that FBAs assign to financial institutions. These component factors address: adequacy of capital; quality of assets; capability of management; quality and level of earnings; adequacy of liquidity; and sensitivity of the institution's earnings or capital to market risk. FBAs assign composite and component ratings of 1 to 5, with 1 indicating the strongest performance and least degree of supervisory concern; and a 5 indicating the weakest performance, and highest degree of supervisory concern.

TARP banks had roughly as many supervisory concerns as did the other banks admitted to the program. Of the 47 banks sampled, 28 were former
TARP recipients that refinanced their TARP investments through SBLF. As shown in Table 1 below, 21 of 28, or 75 percent, of the TARP banks in our sample had supervisory issues compared to 14 of 19, or 74 percent, for non-TARP banks. However, TARP banks had a higher percentage of supervisory issues in more than one category. For example, 11 of 21 (52 percent) of the TARP banks sampled with supervisory issues had two or more categories of concerns compared to 5 of 14 (36 percent) of the non-TARP banks.

Table 1: Numbers of TARP and Non-TARP Institutions with Supervisory Issues

	Asset Quality Issues Only	Earnings Issues Only	Issues In Two or More CAMELS Components	Total
Institutions Refinancing TARP Funds	6	4	11	21
All Other Accepted Institutions	5	4	5	14
Total	11	8	16	35

Reports by FBAs and the Treasury Office of Inspector General (OIG) have shown that these characteristics can contribute substantially to the financial decline of banks. Even if such issues do not affect a bank's viability, they may impair a bank's ability to consistently pay dividends or repay Treasury's investment.

Based on our review of the consultation memoranda and the ARC and IC minutes, we believe that Treasury was aware of the supervisory concerns we identified for all but one of the institutions admitted, and had documented mitigating factors for its decisions. Treasury also informed us that it never intended to restrict the program to institutions without supervisory issues. For example, Treasury approved one institution for the program after asset quality and earnings improved in the second quarter. Treasury admitted a second institution that it initially recommended for withdrawal based on weak earnings, asset quality, and a less-than-satisfactory management rating after second quarter financials showed that asset quality and income had improved over the past year. A third institution had issues with commercial real estate loans and risk management, which Treasury decided had been mitigated in the first half of 2011.

However, while Treasury stated that it was aware of a fourth institution's poor earnings history, it was unaware that the institution's report of examination mentioned 7 years of less-than-satisfactory earnings. We spoke to the responsible FBA officials who stated that by the time the institution was under consideration, it had showed several years of improving earnings in line with projections. The FBA informed us that it, therefore, viewed the information in the report of examination as somewhat stale. The FBA had also generally informed Treasury of the institution's poor earnings history in its supervisory consultation memorandum. The dividend restriction was also at the subsidiary bank level and would not have disqualified the institution from participation in SBLF.

Treasury Gave Applicants Equal Opportunities for Reconsideration

To determine whether applicants had an equal chance for reconsideration, we evaluated a judgmental sample of 34 applicants that Treasury reconsidered after the ARC or the IC initially tabled them or recommended them for withdrawal. According to Treasury, the only intervening events that could result in reconsideration were receipt of either new information from the FBAs or second quarter financial results. Treasury informed us that if the IC could not recommend approval based on first quarter results, it would wait for second quarter results to become available before making a decision.

We determined that Treasury either received updated supervisory information from FBAs or updated financial data for all of the 34 applicants reconsidered, which was documented in the files for the applicants, IC minutes, or ARC minutes. Eighteen applicants were reconsidered based upon new supervisory information, while 16 were reconsidered based upon new financial data. Ultimately, 23 of these applicants were approved, and 11 were asked to withdraw.

Finally, the applicants' files contained no evidence of communication from parties other than the FBAs or financial analysts that Treasury engaged to help evaluate the applicants. If applicants or third parties asked for reconsideration, Treasury informed them that there was no appeals process. Therefore, it appeared that there was no undue influence when reconsidering institutions for approval.

Treasury Had Adequate Bases for Denying Funding to Institutions

The majority of the institutions denied funding in our sample was asked to withdraw their applications because they did not meet the basic eligibility requirements for the program. The Act prohibits Treasury from investing in institutions that are on the FDIC problem bank list or have been removed from the list within 90 days prior to application. It also prohibits the financing of TARP institutions that have missed more than one TARP dividend payment. Further, Treasury guidelines prohibit investments in institutions that are under dividend restrictions from their FBAs or state banking regulators.

Overall, 461 institutions were not admitted to the program of which 262 did not meet the basic eligibility requirements. We reviewed 51 applicants who met basic eligibility requirements, but were not admitted to the program. Of those reviewed, 32 were ineligible because they had dividend restrictions that could not be waived. As a result, they did not receive either ARC or IC review.

The remaining 19 applicants in the sample were eligible for the program and reviewed by the ARC or the IC. However, Treasury identified multiple risks associated with the ability of these applicants to meet their financial commitments under the program. For example, Treasury justified its decision not to invest in three institutions by noting that:

- The first institution had asset quality, management, earnings, and capital issues. One-third of the classified loans were outside the institution's natural market area and in distressed markets. Capital was below a requirement established in a memorandum of understanding with its regulator and earnings were weak. In addition, lender compensation was linked to portfolio size, creating incentives for risky loans.
- A second institution, a bank holding company, was under an enforcement action by its regulator. First-quarter financials showed further deterioration in the applicant's financial condition and its repayment probability was 28 percent. Further, the subsidiary bank had no earnings and could not pay dividends to the applicant holding company, which was currently paying its obligations from cash on hand.
- A third bank was deemed not viable by its FBA and was operating under an enforcement action. In its most recent examination, its

FBA had deemed capital unsatisfactory. Also, almost 100 percent of its assets were classified.

Therefore, Treasury documented its concerns with these institutions and identified issues that might reasonably have justified its decision not to invest.

Recommendation

Because the period of investment for the SBLF program has passed, we have made no recommendations for improving Treasury's investment decision process. However, previously we recommended, and Treasury agreed, to create an internal watch list for banks with more severe financial issues. This will ensure that Treasury has an opportunity to discuss with the banks' management their financial condition if it appears appropriate.

Management Comments and OIG Response

Treasury officials agreed with the report's findings that institutions approved for SBLF participation are likely to be able to repay Treasury's investment, it gave applicants equal opportunity for reconsideration based on consistent criteria, and there was no undue influence in the reconsideration process. In addition, Treasury agreed that it had adequate bases for denying funding to institutions not approved for program participation.

Treasury officials also stated that, as noted in the Recommendation section of the report, it has created and continues to maintain an internal review list of bank participants with certain financial issues. We consider management's comments to be responsive to the audit findings.

* * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 622-1090, or Lisa DeAngelis, Audit Director, at (202) 927-5621.

/s/
Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight

We conducted the audit of investment decisions regarding later-entry, withdrawn and reconsidered institutions in the Small Business Lending Fund (SBLF) program in response to our mandate under section 4107 of the Small Business Jobs Act of 2010.[4] This section provides that the Office of SBLF Program Oversight is responsible for audit and investigations related to the SBLF program and must report at least twice a year to the Secretary of the Treasury and Congress on the results of oversight activities, including recommended program improvements.

Our audit objectives were to determine whether Treasury: (1) consistently approved institutions that were financially viable and able to repay the SBLF investments; (2) were consistent in how they considered institutions that were not approved and asked to withdraw their applications; and (3) had adequate bases for denying funding to institutions. We reviewed three populations: applicants approved and funded between July 27 and September 27, 2011 (during the last 60 days of the program); applicants that were asked by Treasury to withdraw from the SBLF program; and applicants that were reconsidered for SBLF funding.

To accomplish our first objective, we reviewed investment decision records for 47 randomly sampled institutions that Treasury approved and funded within the last 60 days preceding the program's September 27, 2011 funding deadline. These records included Investment Committee (IC) memoranda, Application Review Committee and IC minutes, and applicable correspondence. We also compared supervisory consultative memoranda from the institutions' regulators—the Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC)—to the most relevant bank examination reports prepared by FDIC and OCC to determine whether they provided Treasury with robust and complete information regarding the financial health of the institutions. Where we identified issues from examination reports that had not been disclosed in supervisory memoranda we met with SBLF program staff to determine their awareness of the issues. We also attempted to review a sample of institutions regulated by the Federal Reserve Board (FRB), but the FRB declined to provide us with reports of examination until after the audit work was completed, creating a scope limitation for the first objective of this audit.

[4] The Small Business Jobs Act of 2010, Public Law 111-240, was signed into law on September 27, 2010.

To accomplish our second objective, we reviewed documents supporting Treasury's investment decisions for a judgmental sample of 34 institutions that Treasury identified as being "reconsidered" for SBLF funding. We also reviewed updated financial and regulatory information recorded by Treasury subsequent to its initial review of the reconsidered institutions, and verified that Treasury was not informed of changes that had occurred in the financial condition of institutions that were not reconsidered. We interviewed SBLF staff, and officials from FDIC and OCC. We reviewed applicant files to identify evidence of communication from parties other than the FBAs or the financial analysts that Treasury used to evaluate the applications.

Finally, to accomplish our third objective, we reviewed investment decisions for a sample of 51 institutions that Treasury asked to withdraw from the program between June and September 2011. We obtained information from Treasury regarding the total number of statutorily ineligible applicants.

We conducted our fieldwork from October 2011 to May 2012 in accordance with Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 27, 2012

Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Ms. Ritt:

Thank you for the opportunity to review your draft report (the Report) on the soundness of Small Business Lending Fund (SBLF) investment decisions for later-entry, withdrawn, and reconsidered institutions. This letter provides the Department of the Treasury's (Treasury) official response.

We reviewed the Report's findings, which reflect the SBLF program's comprehensive and transparent investment process. Your audit examined a significant number of SBLF applicants and considered information such as supervisory consultative memoranda from federal banking agencies, relevant bank examination reports, updated financial and regulatory information for some institutions, and documentation supporting Treasury's investment decisions. Treasury agrees with the Report's finding that institutions approved for SBLF participation are likely to be able to repay Treasury's investment.

Treasury also agrees that it gave applicants equal opportunity for reconsideration based on consistent criteria. Treasury only reconsidered an applicant upon receipt of new supervisory information or new financial information, and did not entertain individual requests for reconsideration. Therefore, as the Report finds, there was no undue influence in the reconsideration process.

Finally, Treasury agrees that it had adequate bases for denying funding to institutions not approved for program participation. Treasury denied funding with consistency to applicants that did not meet eligibility requirements, were unable to pay dividends, or exhibited clear risks that could compromise the applicant's ability to meet financial commitments under SBLF.

In closing -- as noted in the recommendation section of the Report -- Treasury has created and continues to maintain an internal review list of bank participants with certain financial issues.

Thank you once again for the opportunity to review the Report. We look forward to working with you and your team in the future.

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Sincerely,

Don Graves Jr.
Deputy Assistant Secretary

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Debra Ritt, Special Deputy Inspector General
Lisa DeAngelis, Audit Director
John Rizek, Supervisory Auditor
Elizabeth MacDonald, Attorney
Bobbi A. Paulson, Referencer

Department of the Treasury

Deputy Secretary
Office of Strategic Planning and Performance Management
Office of Financial Management
Office of Accounting and Internal Control

Office of Management and Budget

OIG Budget Examiner

United States Senate

Chairman and Ranking Member
Committee on Small Business and Entrepreneurship

Chairman and Ranking Member
Committee on Finance

Chairman and Ranking Member
Committee on Banking, Housing and Urban Affairs

United States House of Representatives

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Committee on Small Business

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