Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-11-007

Material Loss Review of Westernbank Puerto Rico, Mayaguez, Puerto Rico

December 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On April 30, 2010, the Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico (OCFI) closed Westernbank Puerto Rico (Westernbank), Mayaguez, Puerto Rico and named the FDIC as receiver. On June 2, 2010, the FDIC notified the Office of Inspector General (OIG) that Westernbank's total assets at closing were $11.1 billion and the estimated loss to the Deposit Insurance Fund (DIF) was $3.3 billion. As required by section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review of the failure of Westernbank.

The audit objectives were to (1) determine the causes of Westernbank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Westernbank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Background

Westernbank was founded as a mutual federal savings bank in 1958, and was then converted to stock ownership in 1985 before becoming a state-chartered commercial bank in 1994. The bank was a wholly-owned subsidiary of W Holding Company, Inc. and headquartered in Mayaguez, Puerto Rico. The bank was the second largest bank in Puerto Rico, operating through a network of 48 bank branches, including 25 branches in the western and southwestern regions of Puerto Rico and 14 branches in the San Juan metropolitan area. The bank's initial lending strategy emphasized long-term fixed rate 1-4 residential mortgage loans, but after becoming a commercial bank, Westernbank shifted its focus to commercial lending. Specifically, Westernbank pursued asset-based lending (ABL), a type of commercial and industrial lending, and commercial real estate (CRE) lending, including acquisition, development, and construction loans (ADC). Puerto Rico's economy has been in the midst of a severe recession for a number of years. Specifically, the Puerto Rico Planning Board reported that the gross national product for the fiscal year ending June 2010 marked the island's fourth consecutive year of economic contraction.

In the 2 years leading up to the Puerto Rico recession, the bank maintained about half of its portfolio in CRE loans, mostly owner occupied, with relatively equal portions in ADC, residential real estate, commercial and industrial, which included ABL, and other loan types. Loans represented about half of the bank's total assets, while the securities portfolio represented about 40 percent. Westernbank, like other banks in Puerto Rico, was also highly dependent on brokered deposits as a result of changes in tax laws. Over the past decade, insured depository institutions in Puerto Rico have become increasingly dependent upon non-core funding, primarily brokered deposits. U.S. tax policy and legislation enacted by the Puerto Rico government, and competition from other banks and financial institutions, have been identified as contributing factors to the funding structure of Puerto Rico banks.

Audit Results

Causes of Failure and Material Loss

Westernbank failed because the Board and management's lending strategy focused on growth without ensuring that credit risk management practices kept pace with the changing loan portfolio. Deficiencies in these practices, particularly as they related to the CRE and ADC portfolios, played a key role in the bank's failure as the portfolio grew significantly just ahead of Puerto Rico's recession. The weak economic environment and strained real estate market accelerated portfolio deterioration.

The Board and management did not address examiner criticisms of weak underwriting and credit administration practices in the ABL portfolio until the 2007 examination, after those practices had contributed to an increase in adverse classifications in ABL. Over that same timeframe, management pursued significant growth in the CRE and ADC portfolios. As Puerto Rico's economy sank into a severe recession, ABL, CRE, and ADC loans that were originated and renewed based on the bank's weak loan underwriting and deficient credit administration practices caused the precipitous deterioration of asset quality and increasingly high levels of adversely classified assets. These conditions necessitated a large increase in provisions for losses, which stressed earnings and eventually eroded the bank's capital. The erosion of capital negatively impacted the bank's liquidity as the bank's ability to renew its brokered deposits became restricted and eventually prohibited. Ultimately, OCFI closed Westernbank because of the bank's inadequate liquidity brought on by the bank's poor asset quality, poor earnings, and inability to obtain additional capital.

The FDIC's Supervision of Westernbank

Historically, Westernbank was well-rated and the bank's financial condition was considered to be sound. Examiners did, however, criticize management's administration of the bank's ABL portfolio in the 2005 examination and repeated those criticisms and noted additional underwriting issues in the 2006 examination. Management's failure to address examiner recommendations from the 2005 examination regarding the loan review function led to criticism from the bank's external auditors and resulted in examiners downgrading the Asset Quality and composite ratings from a "1" to "2" at the 2006 examination. At the 2007 examination, examiners identified significant asset quality problems in the ABL portfolio and attributed the overall deterioration in asset quality to the Board's failure to actively oversee management of this type of lending. Examiners again downgraded the bank's composite and component ratings during that examination signaling some degree of supervisory concern, and Westernbank agreed to an informal supervisory action aimed at correcting identified deficiencies. Although Westernbank's Board and management took steps to address ABL portfolio problems, deterioration emerged in the ADC and CRE portfolios as the economy in Puerto Rico worsened.

Our review focused on the period 2005 to 2010. Notably, in 2006, the FDIC's New York Regional Office (NYRO) recognized the need to closely monitor economic and banking trends in Puerto Rico, and those monitoring efforts led to the development of a comprehensive supervisory strategy for Puerto Rico in 2008 and 2009. As part of that broader strategy, the FDIC's supervisory attention to Westernbank was extensive and comprised of the following elements: (1) annual onsite safety and soundness examinations performed jointly with OCFI, (2) offsite monitoring activities, and (3) targeted asset quality reviews and a horizontal review of loan classifications. The FDIC's supervisory strategy was also instrumental in implementing a well-coordinated resolution of the three Puerto Rico banks that were closed in April 2010.

A general lesson learned with respect to weaknesses in risk management practices, particularly as they relate to the lending function in general and CRE and ADC concentrations, is that early supervisory intervention is prudent, even when an institution is considered *Well Capitalized* and has few classified assets. In that regard, the FDIC began downgrading component and composite ratings at the 2006 examination and further downgraded ratings at subsequent examinations. In addition, the FDIC executed an informal enforcement action following the 2007 examination and a formal enforcement action following the 2008 examination. In hindsight, initiating an informal enforcement action in response to the 2006 examination and imposing a stronger supervisory action in response to the 2007 examination findings may have been prudent, considering that:

- repeated weaknesses were identified in the underwriting and administration of the ABL portfolio at a time when the bank was increasing its emphasis on CRE and ADC;
- Westernbank's increasing CRE and ADC concentrations made it vulnerable to declining economic conditions;
- the FDIC identified Puerto Rico's economy as an emerging risk area in March 2006;
- a strong internal loan review and grading system needed to be in place to ensure timely identification of developing problems and an accurate Allowance for Loan and Lease Losses; and
- unique market factors existed in Puerto Rico, including the degree of competiveness among institutions, that made ADC lending even riskier than in other U.S. markets.

In addition, recognizing that banks in Puerto Rico faced unique challenges in attracting core deposits, greater supervisory attention and earlier criticism of the bank's overall liquidity risk profile might also have been prudent. The 2005, 2006, and 2007 examination reports discussed and included recommendations related to liquidity contingency planning and liquidity stress testing. However, earlier action to address the bank's heavy reliance on brokered deposits could have reduced the bank's high liquidity risk profile and limited, to some extent, the amount of its CRE and ADC lending. The FDIC has taken a number of actions to address banks that have risk profiles similar to Westernbank, including instituting a training initiative on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner.

Management Response

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On December 2, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. DSC reiterated the OIG's conclusions regarding the causes of Westernbank's failure. With regard to our assessment of the FDIC's supervision of Westernbank, DSC summarized its supervisory approach and the progression of component and composite rating downgrades that began in 2006. DSC's response also described enforcement actions taken at subsequent examinations because of the bank's failure to adequately address supervisory recommendations and enforcement measures. Further, DSC's response stated that supervisory guidance has been issued to enhance supervision of institutions, such as Westernbank, with heavy reliance on volatile funding sources. In addition, DSC stated it has completed an examiner training program, as discussed in our report, which emphasizes a forward-looking approach when assessing a bank's risk profile. The early use of informal enforcement actions to pursue corrective of weak risk management practices is consistent with forward-looking supervision.

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FDIC
Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, Virginia 22226

Office of Material Loss Reviews
Office of Inspector General

DATE: December 2, 2010

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

/Signed/
FROM: Stephen M. Beard
Assistant Inspector General for Material Loss Reviews

SUBJECT: *Material Loss Review of Westernbank Puerto Rico, Mayaguez, Puerto Rico* (Report No. MLR-11-007)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of Westernbank Puerto Rico (Westernbank), Mayaguez, Puerto Rico. The Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico (OCFI) closed the institution on April 30, 2010, and named the FDIC as receiver. On June 2, 2010, the FDIC notified the OIG that Westernbank's total assets at closing were $11.1 billion and the estimated loss to the Deposit Insurance Fund (DIF) was $3.3 billion. The estimated loss exceeds the $200 million MLR threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Financial Reform Act.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

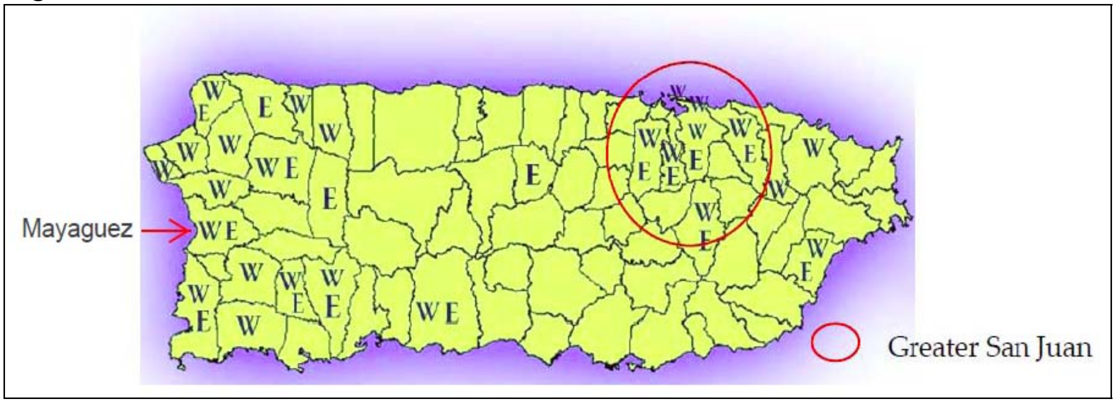
The objectives of this material loss review were to (1) determine the causes of Westernbank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Westernbank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Westernbank's failure and the FDIC's efforts to ensure that the Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss reviews, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[1] Appendix 1 contains details on our objectives, scope, and methodology. We also included several other appendices to this report. Appendix 2 contains a glossary of key terms, including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System, otherwise known as the CAMELS ratings. Appendix 3 contains a list of acronyms. Appendix 4 presents examiner comments on reports of examination from 2005 to 2009. Appendix 5 contains the Corporation's comments on this report.

Background

History and Description of Westernbank

Westernbank was founded as a mutual federal savings bank in 1958, and then was converted to stock ownership in 1985 before becoming a state-chartered commercial bank in 1994. The bank was a wholly-owned subsidiary of W Holding Company, Inc. and headquartered in Mayaguez, Puerto Rico.[2] Westernbank was the second largest bank in Puerto Rico, operating through a network of 48 bank branches, including 25 branches in the western and southwestern regions of Puerto Rico and 14 branches in the San Juan metropolitan area. Figure 1 illustrates Westernbank's branch network.

Figure 1: Westernbank's Branch Network



Source: Westernbank's 2009-2011 Business Plan.
E = Expresso of Westernbank, a division which specialized in small, unsecured consumer loans up to $15,000 and real estate collateralized consumer loans up to $150,000.
W = Westernbank traditional retail banking outlets.

The bank's initial lending strategy emphasized long-term fixed rate 1-4 residential mortgage loans, but after becoming a commercial bank, Westernbank shifted its focus to commercial lending. Specifically, Westernbank pursued asset-based lending (ABL),[3] a

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[1] A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of our report.
[2] Puerto Rico is a territory of the United States (U.S.) and the fourth largest Caribbean island.
[3] ABL is defined as a working capital line of credit to bridge cash flow between the business cycle, which is the collection of receivables and normal operating expenses, and is typically tied and limited to a formula of accounts receivable and inventory. This type of lending requires frequent monitoring of the collateral base by the bank.

type of commercial and industrial (C&I) lending, and commercial real estate (CRE) lending, including acquisition, development, and construction (ADC) loans. In the 2 years leading up to the Puerto Rico recession, the bank maintained about half of its portfolio in CRE, mostly owner occupied; 10-12 percent in ADC; 9-13 percent in residential real estate; 12-13 percent in C&I, which included ABL; and 12-13 percent in other loan types. Loans represented about half of the bank's total assets; the securities portfolio represented about 40 percent. Westernbank, like other banks in Puerto Rico, was also highly dependent on brokered deposits as a result of changes in tax laws discussed in more detail below. Table 1 provides details on Westernbank's financial condition as of March 31, 2010 and for the 5 preceding calendar years.

Table 1: Financial Condition of Westernbank, 2005 to 2010

Financial Measure ($000s)	Mar-10	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets	10,797,345	11,465,784	15,221,770	17,864,793	16,999,476	16,039,232
Total Loans	8,122,144	8,272,477	8,686,588	9,216,411	8,565,557	7,766,730
Total Investments	2,203,515	2,316,210	4,689,966	7,991,284	7,947,707	7,824,779
Total Deposits	8,420,357	8,618,400	10,904,823	10,376,425	9,238,856	8,325,618
Brokered Deposits	5,898,104	6,127,277	8,474,841	7,632,999	6,719,084	5,982,140
Federal Funds	1,352,330	1,744,295	3,160,000	6,101,693	6,320,481	6,260,029
Net Income (Loss)	(89,307)	(482,392)	(3,317)	(69,628)	59,042	122,238

Source: Uniform Bank Performance Reports (UBPR) for Westernbank.

Although the bank had an international division, substantially all of the bank's business activities involved customers located in Puerto Rico. As such, Westernbank, which was 1 of 10 banks operating in Puerto Rico before the bank was closed,[4] encountered intense competition from the other banks and financial institutions in Puerto Rico that are similar to credit unions. In public filings, Westernbank stated that its profitability was dependent on its ability to compete within its market and, to a significant extent, on economic conditions in Puerto Rico.

Economic Conditions in Puerto Rico

Puerto Rico's economy has been in the midst of a severe recession for a number of years. In fact, while the U.S. recession is considered to have ended in June 2009,[5] Puerto Rico's economy remains in a recession. Specifically, the Puerto Rico Planning Board reported that the gross national product for the fiscal year ending June 2010 marked the island's fourth consecutive year of economic contraction. Reported factors contributing to the economic contraction include the significant increase in oil prices, the budgetary pressures on government finances, and continuous loss of manufacturing jobs. The decline in employment on the island has been acute, and the percentage of jobs lost has

[4] Three of the 10 banks in Puerto Rico, Westernbank, Eurobank, and R-G Premier Bank of Puerto Rico (R-G Premier), were closed on April 30, 2010.
[5] In September 2010, the Business Cycle Dating Committee of the National Bureau of Economic Research, an independent group of economists, met and determined that a trough in business activity occurred in the U.S. economy in June 2009. The trough marks the end of the declining phase and the start of a rising phase of the business cycle.

been nearly double the U.S. rate. Between December 2004 and September 2010, Puerto Rico lost 133,000 jobs, a 12.6-percent decline. Unemployment in Puerto Rico also has climbed. The unemployment rate reached 17.2 percent in April 2010, the island's highest rate in 17 years. The unemployment rate eased to 16.0 percent in September 2010 but remains well above the U.S. rate of 9.6 percent.[6] Further, the sharp downturn in the U.S. economy has exacerbated the island's plight as exports of goods to the U.S. have plummeted and tourism has declined.[7]

Although Puerto Rico's economy is closely linked to the U.S. economy, job losses in Puerto Rico pre-date job losses in the U.S. by 3 years and have their root in changes in the island's tax structure. More specifically, the Tax Reform Act of 1976 established the possessions tax credit under Section 936, which was enacted to encourage economic development in U.S. possessions such as Puerto Rico, U.S. Virgin Islands, and Guam. Section 936 exempted U.S. corporations from paying federal income tax on profits generated by a qualified Puerto Rican subsidiary of a U.S. corporation. The stated purpose of this tax credit was to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations." Indeed, while the tax law was in effect, Puerto Rico's manufacturing base experienced strong employment growth.

During the 1980s and early 1990s, several large U.S.-based pharmaceutical, medical equipment, and metals manufacturing companies opened or expanded their operations in Puerto Rico, which resulted in manufacturing surpassing agriculture as the primary source of domestic income. However, legislation enacted in 1996 phased out the tax incentives over a 10-year period and has been identified as a key factor in manufacturing-related job losses on the island. Other reasons cited for the decline in Puerto Rico's manufacturing job base include an escalation in local labor and energy costs relative to international competitors and the loss of patents on some pharmaceutical products that are produced in Puerto Rico.

With regard to the housing sector, similar to the U.S., home prices and new home construction on the island have declined steadily since 2006 and contributed to a sharp decline in the number of construction jobs. The reduction in new construction activity in Puerto Rico occurred about the same time as it did in the U.S., but the percentage declines have been more severe. For example, between June 2004 and June 2009, the island lost one-third of its construction-sector workforce. In contrast, construction-related job losses started 2 years later across the U.S., down approximately 19 percent from 2006.

Funding Structure of Puerto Rico Banks

Over the past decade, insured depository institutions in Puerto Rico have become increasingly dependent upon non-core funding, primarily brokered deposits. Between June 30, 1999 and June 30, 2009, brokered deposits increased from 13 percent to 40

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[6] U.S. unemployment data as of October 2010 from the U.S. Department of Labor, Bureau of Labor Statistics.
[7] For purposes of this discussion, we used U.S. to refer to the 50 states.

percent of total deposits. U.S. tax policy and legislation enacted by the Puerto Rico government, and other sources of competition from "cooperativas" (state-chartered institutions similar to credit unions) have been identified as contributing factors to the funding structure of Puerto Rico banks.

In addition to promoting job growth, while Section 936 was in effect, corporations were subject to a passive income tax on repatriated profits.[8] The tax was passed by the Puerto Rican government and led companies to maintain deposits at local banks, rather than repatriating all profits. This practice resulted in a strong, low-cost funding source for local banks. The repeal of Section 936 had a dramatic impact on local banks' ability to retain their deposits. To illustrate, according to information provided by FDIC officials, it was estimated that banks lost more than 90 percent, or approximately $7.4 billion in deposits, from the manufacturing section in 2003 with the repeal of Section 936.

Additionally, over the last 10 years, Puerto Rico Investment Companies (PRICs) have attracted deposits away from banks. More specifically, the Investment Companies Act of Puerto Rico led to the growth of PRICs, which are similar to mutual funds. Most of these PRICs offer tax-advantageous products that compete directly with bank deposits. "Cooperativas" are another source of competition for retail funding in Puerto Rico. As of March 31, 2009, there were 123 "cooperativas" on the island. As a result of the limited deposit market and the number of institutions on the island, competition for local deposits is strong. In addition, local retail deposits generally tend to be priced higher than brokered deposits and banks find that brokered deposits are a lower cost funding mechanism for growth.

Causes of Failure and Material Loss

Westernbank failed because the Board and management's lending strategy focused on growth without ensuring that credit risk management practices kept pace with the changing loan portfolio. Deficiencies in these practices, particularly as they related to the CRE and ADC portfolios, played a key role in the bank's failure. The weak economic environment and strained real estate market accelerated portfolio deterioration.

The Board and management did not begin to address examiner criticism of weak underwriting and credit administration practices in the ABL portfolio until the 2007 examination, after those practices contributed to an increase in adverse classifications. Over that same timeframe, management pursued significant growth in the CRE and ADC portfolios. As Puerto Rico's economy sank into a severe recession, ABL, CRE, and ADC loans that were originated and renewed based on the bank's weak loan underwriting and deficient credit administration practices caused the precipitous deterioration of asset quality and increasingly high levels of adversely classified assets. These conditions necessitated a large increase in provisions for losses, which stressed earnings and eventually eroded the bank's capital. The erosion of capital negatively impacted the

[8] Those profits that foreign corporations returned to their country from operations in Puerto Rico.

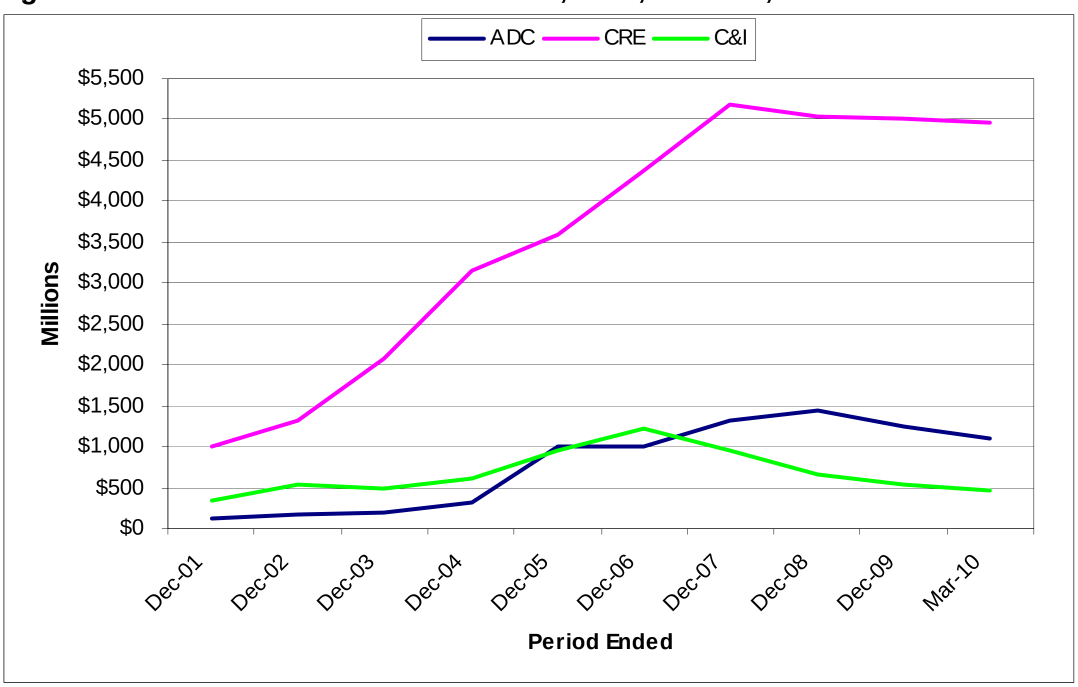
bank's liquidity as the bank's ability to renew its brokered deposits became restricted and eventually prohibited. Ultimately, OCFI closed Westernbank because of the bank's inadequate liquidity brought on by the bank's poor asset quality, poor earnings, and inability to obtain additional capital.

Board and Management's Growth Strategy

Beginning in 2001, the Board and management initiated a growth strategy that focused on increasing its commercial business and real estate loans by pursuing ABL (a type of C&I lending) and CRE lending, which included a substantial number of ADC loans. In general, asset-based credits and construction loans present a higher risk to a financial institution than consumer lending. In short, the Board and management's strategy increased Westernbank's risk profile based on the nature of lending and the concentrations that the bank eventually developed. Further, as discussed in the next section of the report, during this period, while the Board and management focused on growth, initiatives relating to risk management were not given the same level of attention. Credit risk management practices did not keep pace with the changing loan portfolio or the deteriorating Puerto Rico economy.

Westernbank's loan portfolio totaled $2.2 billion and primarily consisted of 1-4 family mortgages as of December 31, 2000. By December 31, 2007, Westernbank's loan portfolio had increased to $9.6 billion, of which 68 percent consisted of CRE and ADC loans. Figure 1 illustrates growth in Westernbank's ADC, CRE, and C&I lending.

Figure 2: Westernbank's Growth in ADC, CRE, and C&I, 2001 to 2010



Source: UBPRs for Westernbank.

As illustrated, Westernbank's growth in C&I, including ABL, occurred between 2004 and 2006. The bank curbed its ABL after examiners and external auditors identified significant problems with its Business Credit Division's underwriting and monitoring procedures. Internal controls and underwriting associated with the ABL were poor and had led to significant losses from fraud and high levels of classified assets. According to examination records, the bank's Business Credit Division provided funds beyond the reasonable repayment capacity of borrowers in an effort to support troubled loan workouts. Frequently, additional funds were collateralized by non-income producing real estate. This practice of over-lending weakened the bank's position because repayment became increasingly more dependent upon the sale of collateral rather than the cash flow from the borrowers' businesses.

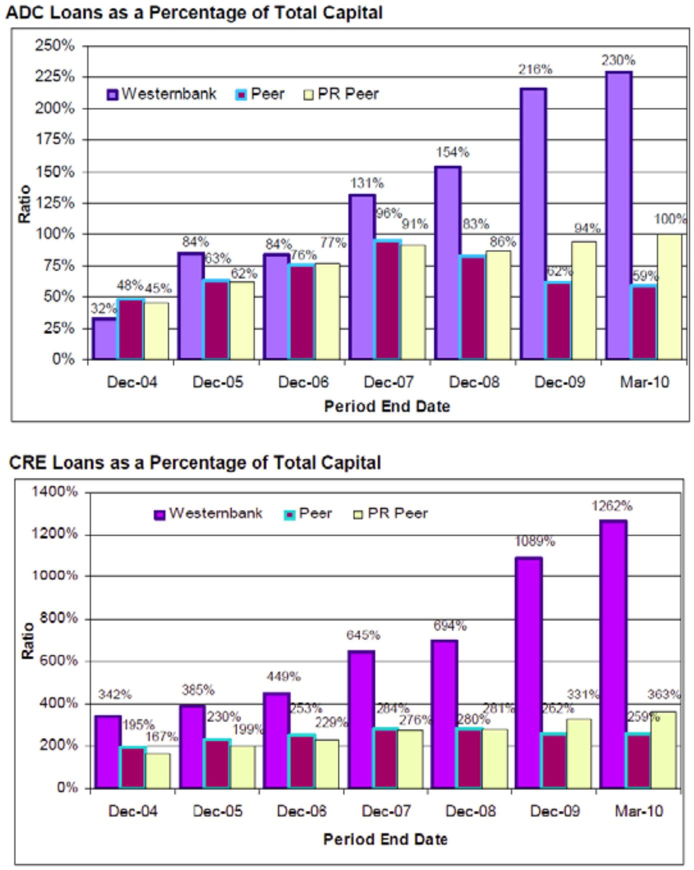
Growth in CRE and ADC lending also occurred during the 2004-2006 period and extended into 2007 when Westernbank decided to curtail CRE and ADC lending because of deteriorating economic conditions. However, by then, the bank had developed sizable CRE and ADC loan portfolios. Repayment of any CRE loan is dependent upon the borrower's ability to produce cash flow from the project through either rental income or the sale of the property. Although collateral value provides certain protection, it does not provide cash flow. Adequate administration and ultimate collectability of these loans requires close monitoring and continuous evaluation of the value of the collateral.

In that regard, the construction lending department routinely provided excessive levels of financing for projects that had failed to perform as originally intended. In addition, the bank's practice, which we understand was consistent with competitors in Puerto Rico, was to provide construction financing without firm pre-sale contracts because developers are not allowed to enter into long-term pre-sales contracts with non-refundable deposits. Thus, a bank's only assurance of commitment to a project is deposits, which are fully refundable. For example, these deposits (referred to as options in Puerto Rico) are generally less than $10,000 with some as low as $2,500 and are refundable upon request for a $50 administrative fee. Because purchase options are entirely in the favor of the buyer, examiners considered Westernbank's residential development projects to be speculative construction loans (i.e., loans that are not accompanied by meaningful pre-sale, pre-lease, or take-out commitments and, therefore, riskier). In addition, the process for obtaining construction permits in Puerto Rico can take between 3 to 5 years, which is longer than in other U.S. markets. This protracted process was another market factor that increased the riskiness of these loans. Lastly, as the economy deteriorated, the construction lending department routinely provided excessive levels of additional financing for projects that had failed to perform as originally intended.

Figure 3 illustrates the percentage of Westernbank's CRE and ADC loans to total capital. Notably, except for ADC levels in 2004, Westernbank's ADC and CRE concentrations exceeded its peer group and other banks in Puerto Rico. For the year-ended December 31, 2008, CRE loans to owner-occupied borrowers amounted to 79 percent of total CRE. As discussed, these loans are sensitive to economic conditions and the cash flow of the borrower's business.

Regulatory guidance emphasizes that rapid growth in CRE, in particular ADC, can present challenges for bank management as it monitors and controls risk it may have not faced in the past. This proved to be true for Westernbank. For example, in 2008, examiners concluded that the bank's deteriorated condition and increased risk profile stemmed primarily from Westernbank's decision to rapidly expand CRE and ADC portfolios without establishing an adequate risk management infrastructure to ensure that the risks associated with this expansion were properly mitigated.

Figure 3: Westernbank's ADC and CRE Lending as a Percentage of Total Capital Compared to Peer, 2004 to 2010



Source: UBPRS for Westernbank.

Note: The significant increase in the concentration ratios in 2009 and 2010 was due primarily to the decline in the bank's total capital.

In December 2006, Federal banking regulatory agencies issued guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance) that reinforces existing regulations and guidelines for real estate lending and safety and soundness.[9] The guidance was issued because the agencies had observed that CRE concentrations had been rising and could create safety and soundness concerns in the event of a significant downturn. Due to the risks associated with CRE and ADC lending, regulators consider institutions with significant CRE and ADC concentrations to be of greater supervisory concern. The Joint Guidance defines institutions with significant CRE concentrations as those reporting loans for construction, land and development, and other land (i.e., ADC) representing 100 percent or more of total capital; or institutions reporting total CRE loans representing 300 percent or more of total capital, where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months.

The Joint Guidance further states that rising CRE concentrations can expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. Earlier supervisory guidance emphasized that ADC lending is a

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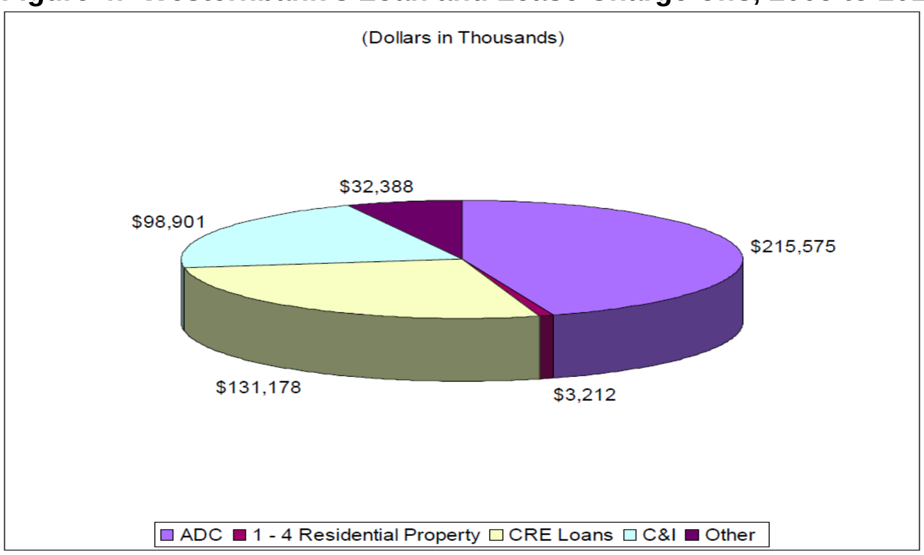
[9] The guidance was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as the agencies in the guidance).

highly specialized field, with inherent risks that must be managed and controlled to ensure that this activity remains profitable.[10] Supervisory guidance also states that an institution's Board is responsible for establishing appropriate risk limits, monitoring exposure, and evaluating the effectiveness of the institution's efforts to manage and control risk.

Although examiners and external auditors first uncovered concerns with the bank's ABL portfolio, ultimately, the CRE and ADC loan portfolios resulted in the largest overall losses to the bank as these types of loans are more vulnerable to declining economic conditions. As of June 30, 2007, the Adversely Classified Items Coverage ratio had increased significantly, from 17.20 percent reported at the prior examination to 40.29 percent. This ratio is a measure of the asset risk and ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor-quality assets and less ability for the bank's capital to absorb any losses associated with those assets. At the 2007 examination, ABL represented 82 percent of total classified loans and totaled $300 million as compared to only $38 million in the CRE portfolio and none in the ADC portfolio. However, by the 2008 examination, adversely classified loans consisted of CRE loans totaling $604 million, ADC loans totaling $575 million, and ABL totaling $430 million. As shown in Figure 4, for the period ending December 31, 2005 to March 31, 2010, most of Westernbank's loan charge-offs involved ADC and CRE loans. Losses resulting from the ABL portfolio made up the vast majority of C&I loan charge-offs.

Figure 4: Westernbank's Loan and Lease Charge-offs, 2005 to 2010



Source: Consolidated Reports of Condition and Income (Call Reports) for Westernbank.

Notably, in the face of a challenging economic environment in 2007 and increasing supervisory concerns, during the fourth quarter, the Board and management largely suspended lending activities, restructured senior management, enhanced risk management

[10] Financial Institution Letter (FIL)-110-98, entitled, *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending,* dated October 8, 1998.

components, and developed a new strategic plan. However, economic conditions continued to worsen, and Westernbank's plans and efforts to address problem loans, diversify its portfolio, and raise capital did not achieve satisfactory results.

Risk Management Policies and Practices

An institution's Board is responsible for establishing appropriate risk limits, monitoring exposure, and evaluating the effectiveness of the institution's efforts to manage and control risk. The Joint Guidance reiterates that concentrations in CRE lending, coupled with weak loan underwriting and depressed CRE markets, contributed to significant credit losses in the past. According to the Joint Guidance:

- strong risk management practices are an important element of a sound CRE lending program, particularly when an institution has a concentration in CRE loans;

- financial institutions with CRE concentrations should ensure that risk management practices appropriate to the size of the portfolio, as well as the level and nature of concentrations, and the associated risk to the institution are implemented; and

- financial institutions should establish a risk management framework that effectively identifies, monitors, and controls CRE concentration risk.

In addition, FIL-22-2008, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, issued March 17, 2008, provides key risk management processes for institutions with CRE concentrations, including maintaining prudent, time-tested lending policies with a strong credit review and risk rating system to identify deteriorating credit trends early and maintaining updated financial and analytical information for borrowers. For example, institutions should emphasize global financial analysis of obligors, which involves analyzing borrowers' complete financial resources and obligations. The guidance further states that inappropriately adding extra interest reserves on loans where the underlying real estate project is not performing as expected can erode collateral protection and mask loans that would otherwise be reported as delinquent.

A significant cause of the decline in asset quality experienced by Westernbank was management's poor risk management practices, including weak loan underwriting and inadequate credit administration, especially during Puerto Rico's severe and prolonged economic recession. The economic decline in Puerto Rico resulted in a significantly depressed real estate market and rapid deterioration in the bank's CRE and ADC portfolios. The fundamental weaknesses in the bank's risk management practices significantly impacted the ability of the bank to identify, measure, monitor, and control the inherent risk in its loan portfolio during the economic downturn.

Loan Underwriting

Weak and liberal loan underwriting standards exacerbated the risks undertaken by management and coupled with the declining economy, were a primary cause of

Westernbank's loan losses. Credit administration issues in the ABL portfolio, which was the largest component of adversely classified loans in the 2007 report, were criticized in the 2005 and 2006 reports, and loan underwriting related to ABL was criticized in the 2006 report. More specifically, in 2005, examiners criticized management's internal loan review process and stressed the imperative for improvement given significant asset growth. Examiners also criticized the disarray and incompleteness of credit files, including the lack of current financial statements. In 2006, examiners made the same criticisms of internal loan review and made note of the external audit criticisms of ABL oversight as well as the concentration of ABL credits in adversely classified and special mention loans.

The 2007 examination noted that the Board's failure to actively supervise management of the ABL portfolio had led to overall asset quality deterioration. The ABL policy and procedures and Board oversight were deemed to need improvement. Criticisms included providing an interest reserve for a large, troubled ABL credit rather than putting it on non-accrual, advancing additional monies to cover past due payments on another large troubled ABL loan, permitting borrowers to deviate from loan terms, and advancing monies outside the asset-based formula for acquisitions of real estate and capitalization of interest. The examination also noted that management had failed to strengthen the bank's internal loan review function, despite repeat recommendations over three examinations and criticisms from its external auditors. In March 2007, management finally employed an experienced loan review officer and organized a fully staffed department. The establishment of a strong internal review function led to the identification of a significant loan fraud in the ABL department just prior to the examination.

During a Targeted Asset Quality Review (TARQ) that was done in August 2008, examiners also identified significant underwriting deficiencies in the bank's deteriorating ABL, ADC and CRE portfolios, as follows:

ABL Portfolio Weaknesses

- **Loans with Questionable Liquidation Value.** Loans were routinely granted based on perceived collateral values, not the debt service capacity of the borrower. These types of loans present additional risk to the bank because the liquidation values become more "suspect" in a declining economic environment.

- **ABL Over-Lending.** As discussed earlier in the report, Westernbank repeatedly provided funds beyond the reasonable repayment capacity of borrowers. As a result, loan repayment was more dependent upon the sale of collateral rather than business cash flow. In most cases, the collateral included a significant amount of real estate, not accounts receivable and inventory as most ABL is designed. Compounding the risk, Westernbank rarely obtained new appraisals to address the changing market place, or required the borrower to fund a substantial portion of the shortfall.

ADC Loan Portfolio Weaknesses

- **Inadequate Borrower Equity.** Westernbank's Loan Policy required developer equity of at least 20 percent of the value of condominium projects that were being financed. However, in 2008, examiners reported that this form of equity generally resulted in the bank taking a much higher level of financial risk than the policy suggests. Examiners reported that the bank rarely obtained significant up-front cash equity. Cash equity provided through the purchase of land for development appears to be the most common, but these amounts were generally nominal relative to the overall project value. Most equity was in the form of hard construction cost retention,[11] which is generally absorbed by construction contractors or builders, and sales commissions. Ultimately, it appears that developers had minimal equity in these projects, and the lack of equity build-up that occurred throughout the construction and sales phases suggested that the bank had nominal collateral protection if the project was not completed and sold at an appropriate amount.

- **Excessive Volume of Loans with High Loan-to-Value (LTV) Ratios.** The lack of borrower equity resulted in high LTV ratios. FDIC Rules and Regulations Part 365, *Real Estate Lending Standards,* Appendix A, *Interagency Guidelines for Real Estate Lending Policies*, states that within the aggregate amount, total loans exceeding the LTV limits for commercial, agricultural, multifamily, or other non-1-4 family residential properties should not exceed 30 percent of the institution's total capital. In contravention of that policy, Westernbank's total LTV exceptions were 46 percent of total capital. In addition, Westernbank frequently originated loans with 100 percent and, often times, greater than 100 percent, financing on ADC loans that also greatly increased the bank's risk exposure.

CRE Weaknesses

- **Other CRE Underwriting Weaknesses.** The 2008 TAQR reported that Westernbank's CRE portfolio also included evidence of poor underwriting practices that were in part attributable to nonexistent policy guidelines. Structural weaknesses described included:

  - Non-existent, weak, or waived covenants;
  - Inadequate debt service coverage;
  - Inadequate financial analysis, insufficient collateral support, and/or insufficient documentation to support collateral valuations/dependency;
  - Liberal repayment program and inadequate guarantor support; and
  - Repayment highly dependent upon asset values.

[11] A percentage of the construction costs incurred by the contractor but not paid by the developer until the project is complete.

Credit Administration

In addition to weak underwriting practices in all loan portfolios, examiners identified numerous deficiencies in management's administration of the ADC portfolio as it became troubled. The following summarizes some of the problems cited in the August 2008 TAQR that ultimately contributed to deterioration in asset quality:

ADC Loan Portfolio Weaknesses

- **Reliance on Faulty Appraisals.** Examiners reported that the bank relied on stale or incomplete appraisals when renewing loans. In many instances, management granted additional funds without obtaining new appraisals. Therefore, the decline in the real estate market was not reflected in the appraisals used to support the loans. As a result, additional funds were granted without any consideration of collateral coverage. Additionally, management had an inadequate appraisal review system. As such, significant errors in appraisals were not identified by management, which routinely contributed to over-lending. In a depressed economy, this practice was particularly risky, as liquidation values became more suspect. In connection with the bank's appraisal practices, examiners cited Westernbank as being in apparent contravention of *Interagency Appraisal and Evaluation Guidelines* and in apparent violation of FDIC's appraisal rules and regulations.

- **Nonaccrual Loan Administration.** The bank did not adopt procedures for the placement of troubled ADC loans in nonaccrual status in accordance with Call Report instructions. As of April 30, 2008, none of the bank's ADC loans were on nonaccrual, despite the large volume of adversely classified ADC loans identified during the 2008 TAQR. Examiners recommended that the bank place all of its ADC loans that were adversely classified during that assessment on nonaccrual status, given the uncertainty surrounding the collectability of principal and interest associated with these loans. The 2009 TAQR results indicated that interest income was overstated to some degree and possibly significantly overstated in some cases because of management's treatment of interest received on nonaccrual loans. In the examiners' view, this practice likely meant that the deterioration in asset quality and earnings were both understated.

- **Interest Reserves.** The bank's Loan Policy did not address the applicability or permissibility of interest reserves and inappropriate usage resulted. Many loans originated with an initial interest reserve were subsequently renewed or extended with additional interest reserves, despite numerous existing credit weaknesses. Additionally, Westernbank frequently used interest reserves on land loans, where development was not imminent. These practices affected the banks recognition of problem credits by keeping underperforming or delinquent loans current. The liberal usage of loan interest reserves, coupled with a slowing real estate market, greatly increased portfolio risk.

General Lending Program Weaknesses

Lastly, examiners identified and criticized the following general loan administration problems at multiple examinations:

- **Legal Lending Limits.** Westernbank was cited in the 2007 and 2008 examinations for violations of the legal lending limit outlined in the Banking Law of Puerto Rico. Specifically, the bank was in apparent violation of Section 17 of Act No. 55, which states that banks may not grant secured loans or transactions that may represent an extension of credit, to the same borrower for an amount greater than 33.33 percent of its paid-in capital, reserve fund, and other components to be determined by the Commissioner from time to time. The bank also violated other lending limits found in Chapter VIII of Regulation 5793 implementing the Act. Specifically, a group of loans were approved for one relationship that exceeded the legal lending limit.

- **Loan Review Program.** Each examination of Westernbank from 2005 to 2008 reported weaknesses in the bank's loan review program, including the lack of analyses of current financial statements, identification of all credit weaknesses and policy exceptions, and reviews of borrowers' compliance with outstanding loan covenants. The failure to grade loans appropriately resulted in management not properly identifying risks within the loan portfolio and failing to recognize loan impairment as required by accounting standards. For example, during the 2008 exam, Westernbank's internal classification report identified just 37 percent of the loans that examiners deemed as adversely classified.

Examples of Poor Underwriting and Credit Administration Practices in ABL Portfolio

As a result, of inadequate underwriting procedures, poor credit administration, and deficient oversight by management, Westernbank originated loan relationships causing individual loan losses exceeding $100 million within its asset-based loan portfolio.

One of these concentrations was the asset-based loans to a pharmaceutical company with international operations. In March 2005, Westernbank originated various loans and lines of credit to three of this firm's subsidiaries totaling $130.4 million in principal value. Under the terms of the loans, Westernbank agreed to provide this firm with credit lines upon which they could draw down based on a percentage of their accounts receivable. Based upon invoices and reports submitted to Westernbank, the bank was assigned approximately $122.5 million in accounts receivable and inventories. The firm agreed to establish "lock box" accounts where customers would remit payments and the deposits would become Westernbank property. By June 28, 2007, the firm had defaulted on various loan agreements and owed Westernbank over $142 million in principal and interest. Westernbank hired an accounting firm to conduct a forensic investigation, which uncovered that the firm had submitted a series of pledged asset reports with rampant irregularities and discrepancies to Westernbank. In addition, the firm was involved in collusion with many of its drug buyers to make payments directly to the firm instead of established lock box accounts. The total cost to Westernbank for the firm credit, including legal and accounting fees was approximately $200 million. Although the firm misled Westernbank, examiners concluded that oversight was lax.

Another of these large individual concentrations was to a company that specializes in the growing processing, and distribution of roasted coffee products. In this case, the firm originated various working capital lines of credit with Westernbank to finance accounts receivable and inventory, and various term loans to finance the acquisition of real estate properties for future developments. Further, the underlying collateral of this credit was considered marginal because appraised real estate values were dependent on extraordinary events and/or hypothetical assumptions. Examiners identified this credit as poorly structured; with overall credit administration weakness and insufficient oversight and the firm accounted for $108 million in adverse classifications in the 2007 examination.

Source: Examination reports for Westernbank.

Allowance for Loan and Lease Losses

According to guidance related to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (ALLL Policy Statement), the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. The ALLL Policy Statement reiterates key concepts and requirements related to generally accepted accounting principles[12] and existing supervisory guidance. Specifically, the ALLL Policy Statement describes (1) the nature and purpose of the ALLL; (2) the

[12] In 2009, the accounting standards were codified. Former Statement of Financial Accounting Standards (FAS) No. 5, *Accounting for Contingencies*, is now covered in Accounting Standard Codification (ASC) Subtopic 450-20. Former FAS No. 114, *Accounting by Creditors for Impairment of a Loan*, is now covered in ASC 310-10-35. These standards provide accounting guidance for loss contingencies on a pool basis and impairment of loans on an individual basis, respectively.

responsibilities of boards of directors, management, and examiners; (3) factors to be considered in the estimation of the ALLL; and (4) the objectives and elements of an effective loan review system, including a sound credit grading system. According to the guidance, an institution's process for determining the ALLL should be based on a comprehensive, well-documented, and consistently applied analysis of its loan portfolio that considers all significant factors that affect collectability. That analysis should include an assessment of changes in economic conditions and collateral values and their direct impact on credit quality. If declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, the ALLL level as a percentage of the portfolio should generally increase, barring unusual charge-off activity.

In 2007, examiners concluded that Westernbank was in contravention of the ALLL Policy Statement as management had not developed written policies and procedures for the maintenance of the ALLL. At the 2008 examination, examiners concluded that the bank's ALLL methodology was no longer appropriate given the changes in the bank's risk profile and asset deterioration. Examiners recommended additional segmentation of the loan portfolio into more discrete loan product descriptions, collateral types, and loan grades and additional documentation to support adjustments made to historical loss rates. As of June 30, 2008, the ALLL totaled $220.9 million, or 2.36 percent of the total loan portfolio. Based on examiner findings and downgrades, the bank's ALLL was found to be deficient in the range of $87 million to $147 million. In addition, the bank was in contravention of the ALLL Policy Statement as a result of management's inability to identify problem loans due to an inadequate loan monitoring system. The deficiencies in Westernbank's loan review system resulted in problem loans not being properly classified in a timely manner.

Reliance on Wholesale Funding Sources

As discussed earlier in the report, banks in Puerto Rico are highly dependent on brokered deposits due to the challenges that banks on the island faced attracting core deposits. Notably, the repeal of Section 936, as well as competition from "cooperativas" and PRICs, contributed to the increased dependence on brokered deposits. Westernbank became increasing reliant on wholesale funding sources, particularly brokered deposits and Federal Home Loan Bank (FHLB) borrowings, to grow its loan portfolio. Historically, the bank was able to effectively maintain sufficient liquidity levels and manage the potential volatility of its funding strategy. However, by 2008, the bank's liquidity position was negatively impacted by the bank's increasingly troubled financial condition.

Between December 2004 and December 2008, Westernbank more than doubled its brokered deposits from $4.2 billion to $8.5 billion. Additionally, from December 2005 through March 2010, Westernbank's brokered deposits comprised no less than 70 percent of the bank's total deposits. This degree of dependence made Westernbank more reliant on wholesale funding than both its bank and state peers. Specifically, as shown in Table 2, Westernbank's net non-core funding dependency ratio consistently and significantly exceeded peer group averages for such funding sources. Generally, the lower the ratio, the less risk exposure there is for the bank, whereas higher rates reflect reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Table 2: Westernbank's Net Non-Core Funding Dependency Ratio

	Mar-10	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05
Westernbank	79.12	82.79	89.97	81.43	81.41	81.17
Bank Peer Group	27.26	28.94	37.67	33.98	33.08	32.33
State Peer Group*	63.17	59.25	68.56	65.52	69.34	69.81

Source: UBPRs for Westernbank.
*Puerto Rico.

The FDIC's Rules and Regulations Part 337, *Unsafe and Unsound Banking Practices*, states that any *Well Capitalized* insured depository institution may solicit and accept, renew, or roll over any brokered deposits without restriction. Under FDIC's Rules and Regulations, restrictions on brokered deposits are imposed when an institution falls below *Well Capitalized*. Under Part 337, *Undercapitalized* and *Adequately Capitalized* institutions are prohibited from obtaining or rolling over brokered deposits; however, *Adequately Capitalized* institutions may request a waiver of the prohibition. As discussed later in this report, in May 2009, Westernbank became subject to a supervisory order with a capital provision that effectively changed the bank's capital level from *Well Capitalized* to *Adequately Capitalized* and prohibited the bank from accepting, renewing, or rolling over brokered deposits unless it had received prior waiver from the FDIC.

In addition to increasing regulatory restrictions, the bank's deteriorating financial condition also caused four brokers that accounted for 43 percent of outstanding brokered deposits to stop selling the bank's certificates of deposit. Although additional brokers were added to replace those brokers and the bank was taking steps to de-leverage the bank and expand other funding sources, examiners remained concerned with Westernbank's ability to obtain sufficient funds to meet its growing liquidity needs.

The FDIC's Supervision of Westernbank

Historically, Westernbank was well-rated and the bank's financial condition was considered to be sound. Examiners did, however, criticize management's administration of the bank's ABL portfolio in the 2005 examination and repeated those criticisms and noted additional underwriting issues in the 2006 examination. Management's failure to address examiner recommendations related to the loan review function from the 2005 examination led to criticisms from the bank's external auditors and resulted in examiners downgrading the Asset Quality and the composite ratings from a "1" to "2" in 2006. At the 2007 examination, examiners identified significant asset quality problems in the ABL portfolio and attributed the overall deterioration in asset quality to the Board's failure to actively oversee management of this type of lending. Examiners again downgraded the bank's composite and component ratings during that examination, signaling some degree of supervisory concern, and Westernbank agreed to an informal supervisory action aimed at correcting identified deficiencies. Although Westernbank's Board and management ultimately took steps to address ABL portfolio problems, deterioration emerged in the CRE and ADC portfolios as the economy in Puerto Rico worsened.

Our review focused on the period 2005 to 2010. Notably, in 2006, the FDIC's New York Regional Office (NYRO) recognized the need to closely monitor economic and banking trends in Puerto Rico, and those monitoring efforts led to the development of a comprehensive supervisory strategy for Puerto Rico in 2008 and 2009. As part of that broader strategy, the FDIC's supervisory attention to Westernbank was extensive and comprised of the following elements: (1) annual onsite safety and soundness examinations performed jointly with OCFI, (2) offsite monitoring activities, and (3) TAQRs and a horizontal review of loan classifications.[13] The FDIC's supervisory strategy was also instrumental in implementing a well-coordinated resolution of the three Puerto Rico banks that were closed in April 2010.

A general lesson learned with respect to weaknesses in risk management practices, particularly as they relate to the lending function in general and CRE and ADC concentrations, is that early supervisory intervention is prudent, even when an institution is considered *Well Capitalized* and has few classified assets. In that regard, the FDIC began downgrading component and composite ratings at the 2006 examination and further downgraded ratings at subsequent examinations. In addition, the FDIC executed an informal enforcement action following the 2007 examination and a formal enforcement action following the 2008 examination. In hindsight, initiating an informal enforcement action in response to the 2006 examination and imposing a stronger supervisory action in response to the 2007 examination findings may have been prudent, considering that:

- repeated weaknesses were identified in the underwriting and administration of the ABL portfolio at a time when the bank was increasing its emphasis on CRE and ADC;
- Westernbank's increasing CRE and ADC concentrations made it vulnerable to declining economic conditions;
- the FDIC identified Puerto Rico's economy as an emerging risk area in March 2006;
- a strong internal loan review and grading system were needed to ensure timely identification of developing problems and an accurate ALLL; and
- unique market factors existed in Puerto Rico, including the degree of competiveness among institutions, that made ADC lending even riskier than in other U.S. markets.

In addition, recognizing that banks in Puerto Rico faced unique challenges in attracting core deposits, greater supervisory attention and earlier criticism of the bank's overall

[13] Nine of the institutions in Puerto Rico were designated as Minority Depository Institutions (MDIs). Recognizing the concentration of MDIs in Puerto Rico and the large asset size of these institutions, the NYRO also held annual MDI conferences in Puerto Rico exclusively for these banks.

liquidity risk profile might also have been prudent. The 2005, 2006, and 2007 examination reports discussed and included recommendations related to liquidity contingency planning and liquidity stress testing. However, earlier action to address the bank's heavy reliance on brokered deposits could have reduced the bank's high liquidity risk profile and limited, to some extent, the amount of its ADC lending. The FDIC has taken a number of actions to address banks that have risk profiles similar to Westernbank, including instituting a training initiative on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management.

Supervisory History

Examination History

From 2005 to 2010, the FDIC and OCFI conducted four joint examinations, three TAQRs of Westernbank, and quarterly Large Insured Depository Institution Program (LIDI) reviews of Westernbank. In October 2009, the FDIC also performed a visitation to assess the bank's liquidity position. Examiners conducted a horizontal review of loan classifications for Westernbank, Eurobank, and R-G Premier in January 2010 to ensure the classifications were being determined consistently. Further, the FDIC monitored the bank's financial condition using various offsite monitoring tools. Table 3 summarizes the examination history of Westernbank from 2005 to 2010.

Table 3: Examination History of Westernbank, 2005 to 2010

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Supervisory Action
7/18/2005	3/31/2005	Joint	112112/1	None
6/19/2006	3/31/2006	Joint	222222/2	Bank Board Resolution (BBR) effective October 2, 2006.*
7/30/2007	6/30/2007	Joint	333423/3	Memorandum of Understanding (MOU) effective February 27, 2008.
3/10/2008	2/28/2008	Joint (TAQR)	N/A	MOU remained in effect.
6/02/2008	4/30/2008	Joint (TAQR)	Asset Quality was downgraded to 4	Results of an offsite review of 9/30/2008 Call Report data resulted in downgrading the Westernbank's composite rating to a "4".
9/29/2008	6/30/2008	Joint	444443/4	Cease and Desist Order (C&D) effective May 22, 2009.
5/11/2009	3/31/2009	Joint (TAQR)	554443/5	C&D remained in effect. Interim downgrade processed on 9/30/2009 based on preliminary findings of TAQR.
11/16/2009**	9/30/2009	Joint	555555/5	C&D remained in effect.

Source: Examination reports and enforcement actions for Westernbank.
*BBR was related to the Bank Secrecy Act.
**The 11/16/2009 examination was not finalized before the bank failed on 4/30/2010.

Offsite Monitoring

In addition to onsite examinations, the FDIC performed quarterly LIDI reviews and continuous offsite monitoring, including periodic contact with bank management and analysis of Call Report data. As part of the FDIC's LIDI program, case managers, along with senior regional management, are generally responsible for ensuring that the level of regulatory oversight accorded to an institution is commensurate with the level of risk it poses to the DIF. Case managers regularly monitor potential risks by reviewing examination reports, analyzing data from quarterly institution Call Reports, and analyzing other financial and economic data from government and private sources to monitor the financial condition of an institution. The offsite review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. The FDIC generates an offsite review list (ORL) each quarter and performs offsite reviews for each bank that appears on the list. The findings of these reviews are factored into examination schedules and other supervisory activities. The system-generated offsite review list includes only institutions rated "1" and "2" that are either:

- identified by Statistical CAMELS Offsite Rating (SCOR) as having a 35-percent or higher probability of downgrade to "3" or worse, or

- identified in the Growth Monitoring System (GMS) as having a growth percentile of 98 or 99.

The FDIC also has a model that measures a bank's exposure to concentrations, the Real Estate Stress Test (REST). The REST model attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that of New England in the early 1990s. According to FDIC information about the REST model, a high REST score does not necessarily mean that the institution is a supervisory concern but indicates a high exposure to a potential economic downturn because of ADC concentrations.

Westernbank was included on the ORL four times based on REST, GMS, and/or SCOR flags. The initial offsite review completed in April 2007 did not reveal any notable changes in the bank's activities and stated that Westernbank's reliance on non-core funding was characteristic of Puerto Rico banks. As such, the offsite review did not prompt any additional follow-up prior to the onsite examination scheduled for July 2007. Subsequent offsite reviews indicated deterioration in most of the bank's component areas, and follow-up activities were either tied to ongoing examinations or planned visitations. However, the findings of an offsite review of September 30, 2008 Call Report data and preliminary results of the June 2008 TAQR resulted in an interim rating change. Specifically, the FDIC downgraded Westernbank's composite rating to a "4" on November 24, 2008.

NYRO Supervisory Strategy for Puerto Rico

In March 2006, the NYRO Regional Risk Committee (RRC)[14] decided to include Puerto Rico as a unique risk area in its quarterly assessment due to emerging concerns associated with economic and banking conditions in Puerto Rico. According to FDIC guidance, the mission of an RRC is to:

- review and evaluate regional economic and banking trends;
- develop follow-up strategies;
- allocate resources, where necessary, to implement follow-up strategies and actions; and
- prepare a regional matrix that summarizes the level of concern (i.e., magnitude of concern) and level of exposure (likely impact of adverse risk areas on the region's banking industry).

Beginning with the March 2006 report, the NYRO RRC quarterly summary reports reflect extensive discussions about economic conditions in Puerto Rico and planned supervisory strategies. In June 2007, the NYRO decided to develop a separate comprehensive supervisory strategy for Puerto Rico for the 2008 examination cycle because economic data revealed 4 consecutive quarters of job losses.[15] Further, the region's assessment of June 30, 2007 Call Report data showed signs of deterioration in the financial performance of banks in Puerto Rico. Specifically, earnings performance had significantly declined during 2007 due to increased provision expenses associated with deterioration in asset quality. At the time, the NYRO was particularly concerned about the potential risks associated with consumer loans.

The region was concerned that overall growth in consumer lending in Puerto Rico, coupled with the extent of job losses, would lead to additional asset quality problems in the future. Puerto Rico banks historically reported a past-due ratio for consumer loans that greatly exceeded the national median ratio. Over the period of 2004-2009, the national median past-due ratio for consumer loans ranged from a low of 1.65 percent as of year-end 2006 to a high of 1.97 percent at year-end 2009. During the same time periods, the Puerto Rico banks reported a low of 3.73 percent in 2005 to a high of 6.95 percent in 2007. The increase in the Puerto Rico past-due levels was of significant concern in 2006 as the Puerto Rico banks in aggregate had consumer loan exposure close to 100 percent of their capital. According to the September 2007 RRC summary report, the region was also beginning to highlight trends in CRE and ADC concentrations in

[14] The FDIC's policy requires that each region have an RRC.
[15] Another area of concern related to accounting issues that were identified in 2005 and early 2006 requiring a number of Puerto Rico banks to restate financial statements. Although Westernbank's holding company was involved in the restatement requirement, in its case, the necessary accounting reclassifications were minimal.

order to identify institutions with concentrations above supervisory thresholds defined in the December 2006 Joint Guidance.

The *2008 NYRO Supervisory Strategy for Puerto Rico* captured (1) an overall view of identified risks for each of the banks; (2) a supervisory snapshot of each bank, including a summary describing each bank's primary business lines; and (3) resource needs. The supervisory strategy was comprised of a combination of point in time examinations, visitations, targeted reviews, horizontal reviews, and quarterly offsite analysis, with an emphasis on evaluating asset quality. The strategy was implemented on January 1, 2008 and updated for 2009.

Another aspect of the region's strategy involved regular communication with officials from Puerto Rico's Governor's offices, including the Government Development Bank (GDB) (the GDB operates in a role similar to that of a central bank) to identify options for reducing the volume of non-performing assets on the island. Efforts were also made to jointly monitor economic conditions with GDB and OCFI to ensure effective communication in the event of one or more bank failures.

Supervisory Response to Board and Management's Lending Strategy and Risk Management Practices

Examiners appropriately identified poor risk management practices in the lending area, made relevant recommendations, and downgraded the bank's asset quality and composite rating at four consecutive examinations, with the second downgrade being accompanied by informal enforcement action through an MOU. These actions were consistent with the principles of the FDIC's forward-looking supervision program. As significant asset quality deterioration emerged, examiners further downgraded component and composite ratings and undertook progressively stronger supervisory actions. Appendix 4 details examiner comments related to these practices in examination reports.

<u>2005 and 2006 Supervisory Activity</u>

Overall, Westernbank was considered to be fundamentally sound in 2005 and 2006 but the Asset Quality component and the bank's composite ratings were downgraded in 2006 from a "1" to a "2". The 2005 examination report stated that this institution continued to be directed by a competent Board and senior management team as evidenced by the overall financial condition of the bank. However, various risk management practices were found in need of improvement. Both the 2005 and 2006 examinations reported that the internal loan review process was in need of improvement and both examinations made specific recommendations in these areas. In fact, the 2005 report stated that due to the institution's significant growth, it was imperative that management implement an effective internal loan review program to ensure an accurate and objective assessment of credit risk within the loan portfolio and an adequate ALLL.

According to the 2006 examination report, Westernbank's classifications were based only on delinquency status and collateral protection. Further, examiners discovered that large loan relationships had not been reviewed for 2 years. In addition, loan relationships were not always reviewed at the same time and, in some instances, updates were performed without the benefit of current financial information. Examiners also found that reporting to the Board and monitoring of corrective action by senior management were both lacking. According to FDIC officials, management's failure to respond to examiner recommendations regarding the internal review process at the 2005 examination contributed to the downgrades at the 2006 examination.

2007 Supervisory Activity

By the July 2007 examination, the effects of the economic downturn in Puerto Rico coupled with the bank's weak risk management practices, began to adversely affect Westernbank's financial condition. Accordingly, examiners downgraded the bank's composite and all component ratings to "3", signaling some degree of supervisory concern. The examination report stated that the Board and management needed to more appropriately identify, measure, monitor, and control risk in the institution and directly attributed the deterioration in the ABL portfolio to the Board's failure to actively supervise management of this type of lending.

Examiners expanded the loan review and targeted Westernbank's ABL portfolio, as weak controls had led to a significant fraud loss in that portfolio earlier in the year. At the end of the examination, classified ABL loans, carried at the bank's Business Credit Division, represented 82 percent of total classified loans. Examiners concluded that most of the ABL loans ultimately classified had been poorly underwritten and were originated during 2004 to 2006, a period of prominent growth. The examination report stated that the Board had not provided clear guidance for acceptable levels of risk exposure with respect to its growth strategy or ensured that appropriate procedures and practices were established. Examiners also expressed concern regarding the lack of effective controls over loan administration and the bank's overall lending structure and staffing. In addition, examiners recommended that the Board consider additional outside directors to provide expertise and offer support to the bank's officers.

The 2007 examination was transmitted to the bank on January 29, 2008. An MOU was executed on February 27, 2008 to address concerns identified in the examination, requiring among other things, that the bank correct apparent violations, conduct a management review, eliminate and develop a plan to reduce adversely classified assets, improve its independent loan review process, and develop a capital plan to ensure it remained *Well Capitalized.*

2008 Supervisory Activity

In March 2008, the FDIC conducted Westernbank's first TAQR that focused on the bank's ADC loans. In this review, examiners identified substantive deterioration in the ADC portfolio associated with the recession, including construction delays, construction cost overruns, slow sales, and limited options to purchase. Examiners classified various credits and also found that management had failed to classify any of the loans in this portfolio despite evidence of credit quality weaknesses. A letter was sent to the Board in April 2008 emphasizing the importance of maintaining proper credit risk identification and monitoring systems in light of the downturn in the economy and declines in the construction sector due to significant speculation and overdevelopment.

In June 2008, the FDIC conducted a second TAQR to further evaluate Westernbank's asset quality that targeted loan underwriting and credit administration practices. The review also assessed the bank's progress in addressing the MOU. The TAQR results indicated that Westernbank's loan portfolios continued to deteriorate due to the recession in Puerto Rico. Specifically, examiners found that construction projects no longer had market feasibility and adequate collateral protection and were negatively affected by construction delays and cost overruns. Further, the bank had not adopted procedures for the placement of troubled ADC loans on nonaccrual status in accordance with Call Report instructions. The bank had not placed any of the ADC loans on nonaccrual status despite the large volume of adversely classified loans identified during the TAQR. Also, management had failed to implement an effective loan review program despite repeated recommendations to do so in the prior four examinations and a provision in the MOU aimed at correcting this deficiency. The results of the TAQR also indicated that management was in non-compliance with provisions of the MOU related to eliminating apparent violations of law or regulations. As discussed earlier, the FDIC notified Westernbank in November 2008 that it was being downgraded to a composite "4" based on the results of this review and offsite analysis of September 30, 2008 Call Report data.

The FDIC and OCFI initiated a full-scope examination on September 29, 2008. The examination report concluded that the Board and management's performance were unsatisfactory and assigned the bank a composite rating to "4". Examiners further concluded that management's decision to engage in rapid expansion of the bank's commercial portfolio, including ABL and ADC loan portfolios during 2002 through 2006, absent an adequate risk management infrastructure, was the catalyst for the current poor condition of the institution. Further, examiners concluded that the Board's supervision of this growth was inadequate, resulting in a large concentration of bank assets in CRE, including a sizeable portfolio of ADC loans.

Examiners found continued significant deterioration in both the ADC and CRE portfolios, which now represented the largest dollar amounts of classified loans at $575 million and $604 million, respectively, compared to the ABL portfolio, which had remained relatively stable at $430 million. The deteriorated condition of the bank was found to warrant a formal enforcement action.

<u>2009 Supervisory Activity</u>

The 2008 examination was transmitted to Westernbank on March 4, 2009, and the bank stipulated to the C&D on April 17, 2009, which became effective on May 22, 2009. Among other things, the C&D required the bank to take specific corrective actions related to its lending practices, including: loan underwriting, appraisal compliance, and other credit administration procedures, and included a capital provision.

A third TAQR commenced in May 2009 and continued to show severe deterioration in the bank's asset quality. Examiners concluded that the local recession as well as the poor economic conditions throughout the entire country had continued to negatively impact the bank's borrowers and led to further deterioration in the bank's loan portfolio. The bank's over-lending practices and deficient loan administration practices had further exacerbated the asset quality problems, and further deterioration in credits was occurring due to declining collateral values. Examiners identified a variety of weaknesses and recommended the bank's Asset Quality rating be downgraded to critically deficient, or a "5" rating. Results of the TAQR indicated that Westernbank was in non-compliance with the C&D and that the bank's overall financial condition was rapidly deteriorating.

FDIC and OCFI officials worked with Westernbank in an attempt to correct deficiencies in the bank's practices and take actions to work out loans to improve the bank's financial condition. However, the bank's financial condition continued to deteriorate as declining asset quality associated with the deepening recession in Puerto Rico caused loan losses that negatively affected the bank's earnings and capital levels. In response to these conditions, on September 29, 2009, the FDIC notified Westernbank that the Asset Quality, Capital, and composite ratings were being downgraded to "5". The results of the TAQR were rolled into the full-scope examination initiated in November 2009, but Westernbank was closed prior to issuance of the report.

2010 Supervisory Activity

During 2010, examiners focused on completing the full-scope examination started in November 2009. In January 2010, examiners for Westernbank and two other Puerto Rico banks also conducted a horizontal review to ensure classifications of CRE loans were consistent. In addition, during the first quarter, FDIC officials met with Westernbank numerous times to discuss various issues, including brokered deposits and the bank's capital plan.

Supervisory Lessons Learned

At the time Westernbank was implementing its growth strategy in ABL, CRE, and ADC loans, federal banking agency examiners were generally observing that institutions were relaxing underwriting standards as a result of strong competition for business. Further, specific risk management weaknesses were identified in Westernbank's loan review and grading system and ABL underwriting and administration practices. As discussed earlier in this report, and acknowledged in the NYRO's supervisory strategy, market factors in Puerto Rico made ADC lending riskier and warranted additional supervisory attention. A general lesson learned with respect to weaknesses in risk management practices, particularly as they relate to the lending function in general and CRE and ADC concentrations in particular, is that early supervisory intervention is prudent, even when an institution is considered *Well Capitalized* and has few classified assets.

The FDIC began progressively downgrading Westernbank's component and composite ratings at the 2006 examination, initiated an informal enforcement action at the 2007 examination, and imposed a formal enforcement action to secure corrective action following the 2008 examination. In hindsight, initiating an informal supervisory action in response to the 2006 examination and imposing a stronger supervisory action in response to the 2007 examination findings may have been prudent. These steps may have led to more prompt correction of deficient practices and limited growth before economic conditions made it difficult for the bank to address problems.

The FDIC has taken a number of actions to increase supervisory attention to banks that have risk profiles similar to Westernbank. Of note, in March 2010, the FDIC completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The FDIC has also issued updated guidance to examiners regarding CRE loan examination procedures in view of more challenging market conditions, particularly in ADC lending, and supervisory expectations for FDIC-supervised institutions to update real estate appraisals and evaluations.

Supervisory Response to Reliance on Wholesale Funding Sources

2005 to 2010 Supervisory Activity

In 2005, 2006, and 2007, examiners viewed Westernbank's liquidity to be strong and/or satisfactory, although examiners noted the potential volatility of the bank's heavy reliance on non-core funding. Accordingly, Liquidity was rated "1" in 2005 and 2006 and "2" in 2007. Westernbank's high reliance on brokered deposits was considered to be characteristic of Puerto Rico banks, and the bank had a liquidity contingency plan in place. Examiners did, however, make recommendations in both the 2005 and 2006 examinations aimed at improving the bank's liquidity contingency plan, liquidity measurement tools, and liquidity risk limits consistent with supervisory guidance. Similar recommendations were made at the 2007 examination and examiners downgraded the Liquidity component rating from "1" to "2". For example, the 2007 examination report noted that the bank depended significantly on the constant roll-over and market availability of brokered deposits and recommended that Westernbank's CFP be updated regularly to:

- Define responsibilities and decision-making authority during a problem-funding situation.
- Include an assessment of the possible liquidity events that the institution may encounter.
- Assess the potential for erosion by funding source under various scenarios.
- Identify the sequence in which sources of funds will be used for contingent needs.
- Identify the conditions related to the use of back-up facilities and the circumstances where the institution may use them, and test the ability to borrow from established back-up facilities.
- Establish the timeframes for reporting in a problem liquidity situation.

- Establish an asset tracking system to identify how much a cash sale of assets will generate.

By 2008, the financial condition of the bank had deteriorated significantly, and the bank's reliance on brokered deposits became a concern, and the Liquidity component was downgraded to a "4" rating. A "4" rating indicates deficient liquidity levels or inadequate funds management practices. Further, institutions assigned this rating may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs. Indeed, several key brokers were no longer willing to sell Westernbank's certificates of deposit due to impending enforcement actions. The examination report stated that the bank's continued reliance on brokered funds, without appropriate risk limits, had resulted in the bank's immediate need for alternate funding sources to replace those funds that were not rolled over by brokers. The bank commenced daily liquidity reporting to the FDIC on September 29, 2008.

On September 30, 2008, examiners met with Westernbank's management to discuss alternate funding sources, and meeting participants concluded that without the ability to obtain and roll over brokered deposits, the bank could not survive. The bank was in the process of analyzing loans available to pledge as collateral to the FHLB and the Federal Reserve Bank. However, the bank's ability to obtain additional capacity at the FHLB or any borrowings from the discount window was questionable given the asset quality deterioration. In short, the bank's continued dependence on brokered deposits raised liquidity concerns because of the bank's poor financial condition. The examination recommended that management revisit and document the adequacy of the bank's liquidity risk limits based on the bank's current poor financial condition and contingent liquidity needs.

In addition, the May 2009 C&D contained provisions that required the bank, within 60 days of the effective date of the C&D, to submit in writing to the Regional Director an acceptable, comprehensive liquidity contingency plan. The plan needed to:

- address the means by which the bank would reduce its reliance on non-core funding and high-cost, rate-sensitive deposits;

- assess possible liquidity events that the bank might encounter; and

- identify responses to the potential impact of such events on the bank's short-term, intermediate-term, and long-term liquidity profile.

In response to the C&D, Westernbank submitted an updated liquidity contingency plan in July 2009 but the plan was based on the premise that the bank would remain a viable financial institution. However, the continued deterioration of asset quality led to deficient capital, and Westernbank's access to external funding sources was limited. Eventually, Westernbank's liquidity became insufficient to sustain operations.

On August 20, 2009, the FDIC sent a letter related to section 337.6 of the FDIC Rules and Regulations describing deposit pricing restrictions for banks that are less than *Well*

Capitalized. The FDIC performed a visitation on October 26, 2009 that focused on assessing the bank's liquidity position and compliance with the brokered deposit waiver. The visitation noted that the bank's liquidity remained deficient due to an extremely high dependence on brokered deposits and the less than *Well Capitalized* PCA designation. The visitation findings also indicated that the bank did not possess sufficient liquid assets and borrowing capacity to remain viable for any length of time without a brokered deposit waiver.

Brokered Deposit Waivers

As discussed earlier in this report, the May 2009 C&D included a capital provision that effectively changed the bank's capital level from *Well Capitalized* to *Adequately Capitalized*. Thus, Westernbank was prohibited from accepting, renewing, or rolling over brokered deposits without receiving a brokered deposit waiver from the FDIC. The FDIC approved three brokered deposit waivers between May 2009 and March 2010, as follows:

- On April 17, 2009, Westernbank submitted its first brokered deposit waiver application. Initially, the bank requested the ability to renew/roll over 100 percent of maturing brokered deposits until the bank returned to the *Well Capitalized* designation. However, in order to reduce risk to the DIF, the FDIC advised management to limit the brokered deposit waiver request. Westernbank subsequently revised its application and requested the ability to renew or roll over 50 percent of maturing brokered deposits, or $1.5 billion over the next 6 months, or through November 30, 2009. The FDIC approved the revised brokered deposit waiver on May 22, 2009.

- On November 4, 2009, the FDIC received Westernbank's second brokered deposit waiver application. This application was approved on December 9, 2009 and allowed the bank to renew or roll over 75 percent, or up to $1.26 billion of brokered deposits that matured from December 1, 2009 through March 31, 2010.

- On March 9, 2010, the FDIC received the bank's third brokered deposit waiver application. This application was approved on March 29, 2010, and allowed the bank to renew/roll over 75 percent, or up to $268 million of brokered deposits that mature in April 2010.

In each case, the FDIC concluded that the brokered deposit waiver would not result in an unsafe or unsound practice.

Preliminary results of the May 2009 TAQR identified substantial deterioration in the bank's loan portfolio and the overall financial condition of the institution. Further, examiners believed that the bank's capital ratios were likely inflated due to deficiencies associated with the bank's FAS 114 analysis and may have fallen to *Undercapitalized*. As previously discussed, an *Undercapitalized* insured depository institution is prohibited from accepting, renewing, or rolling over any brokered deposits. The preliminary results of the TAQR were significantly different from internal bank classifications, which had relied on stale appraisals. Accordingly, to ensure the accuracy of its analysis by allowing management time to obtain new appraisals, the FDIC decided to roll the May 2009 TAQR results into the November 16, 2009 full-scope examination. Further, the FDIC initiated a horizontal review of CRE loan classifications at Westernbank, Eurobank, and R-G Premier in January 2010.

According to Part 325 of the FDIC's Rules and Regulations,[16] a bank is deemed to be within a given capital category for purposes of section 38 of the FDI Act as of the most recent date that:

- a Call Report is required to be filed with the FDIC;
- a final report of examination is delivered to the bank; or
- written notice is provided by the FDIC to the bank of its capital category for purposes of section 38 of the FDI Act.

In this case, the FDIC did not hold an exit meeting with management to discuss findings of the 2009 examination until April 27, 2010 when findings were finalized and, at that time, hand-delivered a letter notifying the bank of its new PCA capital category, S*ignificantly Undercapitalized,* and brokered deposit restrictions.

Supervisory Lessons Learned

Liquidity risk is defined as the risk that an institution's financial condition or overall safety and soundness is adversely affected by an inability (or perceived inability) to meet obligations. In hindsight, earlier supervisory action to address Westernbank's increasing dependence on brokered deposits may have been prudent, especially considering that Westernbank used brokered deposits not just to sustain operations but to fund aggressive growth in higher-risk CRE and ADC lending, which can increase a bank's vulnerability to economic conditions. To that end, a more forward-looking approach to liquidity planning might have been beneficial in prompting the bank to take earlier action to reduce its dependence on this funding. The FDIC has taken a number of actions to increase supervisory attention to banks that have risk profiles similar to Westernbank. The FDIC has issued the *Policy Statement on Funding and Liquidity Risk Management*,[17] which stresses that changes in economic conditions, among other things, can affect an institution's liquidity risk profile and should be considered in the assessment of liquidity.

Implementation of PCA

Section 38, *Prompt Corrective Action,* of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all insured depository

[16] For purposes of section 29 of the FDI Act and section 337.6, the terms *Well Capitalized, Adequately Capitalized,* and *Undercapitalized,* have the same meaning to each insured depository institution as provided under regulations implementing section 38 of the FDI Act.
[17] This policy statement was issued by Federal banking agencies on March 17, 2010.

institutions. The section requires that regulators take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC's Rules and Regulations, defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38.

Based on the supervisory actions taken with respect to Westernbank, the FDIC properly implemented applicable PCA provisions of section 38. Westernbank was considered *Well Capitalized* for PCA purposes until April 16 2009. Table 4 illustrates Westernbank's capital levels from 2008 to 2010.

Table 4: Westernbank's Capital Categories, 2008 to 2010

Exam /Visit Date	Tier 1 Leverage	Tier 1 Risk-Based	Total Risk-Based	Capital Classification
Well-Capitalized Threshold	**≥ 5%**	**≥ 6%**	**≥ 10%**	
9/29/2008 Joint Examination	5.55	8.88	10.15	*Well Capitalized*
11/03/2009 TAQR	5.73	9.23	10.50	*Adequately Capitalized*
4/27/2010 PCA Notification Letter	3.67	5.54	6.83	*Significantly Undercapitalized*

Source: ROEs, TAQR, and UBPRs for Westernbank.

Westernbank was considered *Well Capitalized* at its September 2008 joint examination.[18] However, as previously mentioned in this report, as a result of the May 2009 C&D, the bank effectively became *Adequately Capitalized* for PCA purposes and remained so until April 2010. The C&D included a capital provision that specifically directed Westernbank to increase and maintain a Tier 1 Leverage Capital ratio of at least 6 percent by March 31, 2010. The C&D also required the institution to develop a liquidity contingency plan to reduce its reliance on brokered deposits. The following summarizes the FDIC's monitoring activities related to the C&D capital provision:

- **August 10, 2009.** FDIC officials met with senior bank management to discuss capital initiatives being explored. Management stated that approximately $15 million in capital would be transferred from the holding company. In addition, management indicated that it was pursuing expansion of the FHLB Borrowing line.

- **November 2, 2009.** The FDIC sent a letter to the Board outlining deficiencies with the bank's proposed capital plan.

[18] Westernbank submitted an application for assistance under the Troubled Asset Relief Program (TARP) on October 22, 2008 for funding of $250 million. The FDIC was in the process of reviewing the application when Westernbank withdrew its TARP application on December 19, 2008.

- **March 29, 2010.** FDIC officials again met with senior bank management to discuss capital-raising initiatives.

- **April 15, 2010.** The FDIC advised the bank that its capital plan was unacceptable and requested that the bank immediately provide the FDIC with its plans to contribute capital and/or sell itself or merge with another federally insured depository institution.

On April 27, 2010, Westernbank was informed that the bank's PCA capital category had fallen to *Significantly Undercapitalized* and the bank was closed on April 30, 2010.

Corporation Comments

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On December 2, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 5 of this report. DSC reiterated the OIG's conclusions regarding the causes of Westernbank's failure. With regard to our assessment of the FDIC's supervision of Westernbank, DSC summarized its supervisory approach and the progression of component and composite rating downgrades that began in 2006. DSC's response also described enforcement actions taken at subsequent examinations because of the bank's failure to adequately address supervisory recommendations and enforcement measures. Further, DSC's response stated that supervisory guidance has been issued to enhance supervision of institutions, such as Westernbank, with heavy reliance on volatile funding sources. In addition, DSC stated it has completed an examiner training program, as discussed in our report, which emphasizes a forward-looking approach when assessing a bank's risk profile. The early use of informal enforcement actions to pursue corrective of weak risk management practices is consistent with forward-looking supervision.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, as amended by the Financial Reform Act, which provides, in general, that if the DIF incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The Financial Reform Act amends section 38(k) of the FDI Act by increasing the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38.

We conducted this performance audit from July 2010 to November 2010 in accordance with generally accepted 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.

Scope and Methodology

The scope of this audit included an analysis of Westernbank operations from 2005 until its failure on April 30, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

To achieve the objectives, we performed the following procedures and techniques:

- Analyzed examination reports prepared by the FDIC and the OCFI examiners from 2005 to 2009.

- Reviewed the following:

    - Bank data and correspondence maintained at the FDIC's New York Regional Office and San Juan, Puerto Rico Field Office.

    - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.

    - Pertinent DSC policies and procedures and various banking laws and regulations.

Objectives, Scope, and Methodology

- Interviewed the following FDIC officials:

  - DSC management in Washington, D.C. and the New York Regional Office and San Juan, Puerto Rico Field Office.

  - FDIC examiners from the New York Regional Office and San Juan, Puerto Rico Field Office, who participated in examinations or reviews of examinations of Westernbank.

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance with Laws and Regulations

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, examination reports, and interviews of examiners to understand Westernbank's management controls pertaining to causes of failure and material loss as discussed in the body of this report.

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests were discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Objectives, Scope, and Methodology

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions and these reports can be found at www.fdicig.gov. In June 2010, the OIG initiated an audit, the objectives of which are to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

In addition, with respect to more comprehensive coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and that provide interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL 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. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Bank Board Resolution (BBR)	A Bank Board Resolution is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Bank Secrecy Act (BSA)	Congress enacted the BSA of 1970 to prevent banks and other financial service providers from being used as intermediaries for, or to hide the transfer or deposit of money derived from, criminal activity. The BSA requires financial institutions to maintain appropriate records and to file certain reports, including cash transactions over $10,000 via the Currency Transactions Reports (CTR). These reports are used in criminal, tax, or regulatory investigations or proceedings.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.

Glossary of Terms

Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. section 1818 to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 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 concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Contingency Funding (or Liquidity) Plan	A written plan that defines strategies for addressing liquidity shortfalls in emergency situations. Such plans delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. Contingency funding plans should be regularly tested and updated to ensure that they are operationally sound. DSC uses the term contingency funding plan and contingency liquidity plan interchangeably.
Criticized Assets	Criticized assets include all assets rated special mention, substandard, doubtful, and loss. The Board of Governors of the Federal Reserve System, the FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the agencies) Uniform Loan Classification Standards, along with the agencies' examination manuals, define these risk rating classifications.
FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.

Glossary of Terms

Federal Home Loan Bank (FHLB)	FHLBs provide long- and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans, and government and agency securities. Community financial institutions may pledge small business, small farm, and small agri-business loans as collateral for advances. Advances are priced at a small spread over comparable U.S. Department of the Treasury obligations.
Financial Holding Company	A financial entity engaged in a broad range of banking-related activities, created by the Gramm-Leach-Bliley Act of 1999. These activities include: insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, issuing or selling securitized interests in bank-eligible assets, and generally engaging in any non-banking activity authorized by the Bank Holding Company Act. The Federal Reserve Board is responsible for supervising the financial condition and activities of financial holding companies.
Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: guarantor's related debt at other financial institutions, future economic conditions, as well as obtaining current and complete operating statements of all related entities. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan.
Growth Monitoring System (GMS)	GMS is an offsite rating tool that identifies institutions experiencing rapid growth or having a funding structure highly dependent on non-core funding sources.
Large Insured Depository Institution (LIDI) Program	The FDIC established the LIDI program to assess and report on emerging risks at all institutions with total assets of $10 billion or more as well as other selected institutions. Under this program, regional case managers perform ongoing analyses of emerging risks within each insured institution and assign a quarterly risk rating. Case managers also maintain contact with the primary federal regulator for each institution in the LIDI program. Data obtained through this program are analyzed and key issues are reported to corporate executives regularly for use in policy and operational discussions. In addition, senior financial institution analysts with the Complex Financial Institutions Branch complete offsite analyses in order to meet the Corporation's risk information needs and form appropriate supervisory strategies.
Loan-to-Value	A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral.

Glossary of Terms

Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Nonaccrual Status	The status of an asset, often a loan, which is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status.
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
Problem Bank Memorandum	A problem bank memorandum documents the FDIC's concerns with an institution and the corrective action in place or to be implemented and is also used to effect interim rating changes on the FDIC's systems.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized.

Glossary of Terms

Real Estate Stress Test (REST)	REST attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that of New England in the early 1990s. REST uses statistical techniques to forecast an institution's condition over a 3- to 5-year horizon and provides a single rating from 1 to 5 in descending order of performance quality.
Risk-Based Capital Rules	Appendix A to Part 325—*Statement of Policy on Risk-Based Capital*—defines the FDIC's risk-based capital rules. Appendix A states an institution's balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to broad risk categories according to the obligor or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the four risk categories are added together and this sum is the risk-weighted assets total that, as adjusted, comprises the denominator of the risk-based capital ratio. The institution's qualifying total capital base is the numerator of the ratio.
Statistical CAMELS Offsite Rating (SCOR) System	SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Department of the Treasury to purchase assets and equity from financial institutions to strengthen the financial sector.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

Glossary of Terms

Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.
Wholesale Funding	Wholesale funding sources include, but are not limited to, Federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or CD listing services. Financial institutions may use wholesale funding sources as an alternative to core deposits to satisfy funding and liability management needs.

Acronyms

ABL	Asset-Based Lending
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ASC	Accounting Standard Codification
C&D	Cease and Desist Order
C&I	Commercial and Industrial
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FAS	Financial Accounting Standards
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GBD	Government Development Bank
GMS	Growth Monitoring System
LTV	Loan-to-Value
MLR	Material Loss Review
MOU	Memorandum of Understanding
NYRO	New York Regional Office

Acronyms

OCFI	Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico
OIG	Office of Inspector General
PCA	Prompt Corrective Action
PRIC	Puerto Rico Investment Companies
REST	Real Estate Stress Test
ROE	Report of Examination
RRC	Regional Risk Committee
SCOR	Statistical CAMELS Offsite Rating System
TAQR	Targeted Asset Quality Review
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
U.S.	United States

Examiner Comments in Reports of Examination

ROE Dates	2005	2006	2007	2008	2009
Deficiency/Risk					
Administration Weaknesses in Business Credit Division/ABL	✓	✓	✓	✓	
Concentration in CRE and ADC Loans	✓			✓	✓
Concentration of Other Credit – Other Financial Institutions			✓		
Loan Underwriting					
Overall Weak/Liberal Underwriting Deficiencies			✓	✓	✓
Interest Reserves/Lack of Justification for Replenishing				✓	✓
Inadequate Appraisal Program/Review				✓	✓
High LTV				✓	✓
Loans without Adequate Owner Equity in Underlying Real Estate Collateral/Questionable Liquidation Value				✓	✓
Credit Administration					
Inadequate Internal Loan Review	✓	✓	✓	✓	✓
Inadequate identification of all credit weaknesses and policy exceptions.	✓				
Improper accounting treatment of Doral and R-G Premier loan purchases		✓			
Inadequate ALLL Methodology			✓	✓	✓
Improper Capitalization of Interest and Past Due Payments			✓		
Inadequate Loan Administration		✓	✓	✓	✓
Increased oversight/monitoring/tracking of CRE/ADC concentration needed			✓	✓	
Increase in Past-Due and Non-Accrual Loans			✓	✓	
Lack of Disposition of Classified Assets			✓	✓	
Overlending				✓	
Failure to Enforce Liquidation Programs				✓	
Inadequate or the Lack of Global Cash Flow Analysis/Repayment Capacity/Borrower Equity				✓	
Apparent Violations or Contraventions					
Part 365 Part A – Real Estate Lending Standards	✓			✓	
Contravention of the FDIC Statement of Policy –Guidance for maintaining ALLL at an appropriate level			✓	✓	
Interagency Appraisal and Evaluation Guidelines			✓	✓	
Banking Law of Puerto Rico – Legal Lending Limits			✓	✓	
Banking Law of Puerto Rico – Legal Reserve			✓		
Part 323-Appraisal Violation				✓	
Part 363 – Filing of Annual Reports				✓	

Source: Examination reports for Westernbank.

Corporation Comments

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Supervision and Consumer Protection

December 1, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson [signed by Sandra L. Thompson]
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of Westernbank, Mayaguez, Puerto Rico (Assignment No. 2010-069)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Westernbank, Mayaguez, Puerto Rico, which failed on April 30, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on November 10, 2010.

Westernbank failed because the Board's and management's lending strategy focused on growth without ensuring that credit risk management practices kept pace with the changing loan portfolio. Weaknesses in Westernbank's loan review function resulted in significant losses in its asset-based lending portfolio, eventually leading to the cessation of this type of lending. Westernbank then refocused its lending activities into acquisition, development and construction and commercial real estate, without enhancing its credit risk management practices. Deficiencies in these practices played a key role in Westernbank's failure, resulting in loan losses that were accelerated by the weak economic environment and strained real estate market. Erosion of capital associated with loan losses restricted and eventually prohibited Westernbank from renewing its brokered deposits, which it relied upon to support its operations. Ultimately, Westernbank was not considered viable because of its deteriorating asset quality, poor earnings and inadequate capital.

The FDIC's supervisory attention to Westernbank was extensive, and included onsite joint annual examinations with the Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico (OCFI), offsite monitoring activities and targeted asset quality reviews. Beginning with the 2006 examination, the asset quality component and composite ratings were downgraded based on weaknesses in the loan review function. Weaknesses persisted, and the FDIC and OCFI continued to progressively downgrade component and composite ratings and used enforcement actions to secure Westernbank's correction of deficiencies. Westernbank's Board and management failed to adequately address supervisory recommendations and enforcement measures.

DSC issued a Financial Institution Letter in 2009 on *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition* to enhance our supervision of institutions, such as Westernbank, with heavy reliance on volatile funding sources. Additionally, DSC has completed an examiner training program that emphasizes a forward looking approach when assessing a bank's risk profile. The training reinforced consideration of risk management practices in conjunction with current financial performance, conditions, or trends when assigning ratings and contemplating corrective actions. The early use of informal enforcement actions to pursue correction of weak risk management practices is consistent with forward looking supervision.

Thank you for the opportunity to review and comment on the Report