Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-11-009

Material Loss Review of R-G Premier Bank of Puerto Rico, Hato Rey, 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 R-G Premier Bank of Puerto Rico (R-G Premier), Hato Rey, Puerto Rico, and named the FDIC receiver. On June 2, 2010, the FDIC notified the Office of Inspector General (OIG) that R-G Premier's total assets at closing were $6 billion and the estimated loss to the Deposit Insurance Fund (DIF) was $1.2 billion. As required by section 38(k) of the Federal Deposit Insurance (FDI) 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.

The objectives were to (1) determine the causes of failure for R-G Premier and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

Background

R-G Premier was 1 of 10 banks operating in Puerto Rico before the bank was closed. Three of these 10 banks—R-G Premier, Westernbank Puerto Rico, and Eurobank—were closed on April 30, 2010. The closure of these banks followed several years of severe economic recession in Puerto Rico. Further, insured depository institutions in Puerto Rico have become increasingly reliant on non-core funding sources, particularly brokered deposits, over the past decade. This reliance on brokered deposits has been attributed to several factors, including U.S. tax policy, legislation enacted by the Puerto Rico government, and competition for retail deposits.

R-G Premier was established in 1983 as a federal savings bank. The FDIC became the institution's primary federal regulator in November 1994 when R-G Premier converted to a state-chartered nonmember bank. Between 1994 and 2004, R-G Premier grew its total assets from $460 million to over $9 billion. The bank's lending activities during this period focused primarily on 1-to-4 family residential properties. From 2004 until it failed, R-G Premier experienced almost no growth in its loan portfolio, and its total assets declined. In addition, the bank had a diverse loan portfolio consisting of commercial real estate (CRE) loans; acquisition, development, and construction (ADC) loans; commercial and industrial loans; and residential real estate loans. However, risk within the loan portfolio grew as ADC loans increased between 2004 and 2008. In addition to a main office in Hato Rey, R-G Premier operated a network of 32 branches throughout Puerto Rico. The institution was wholly-owned by R&G Financial Corporation (RGFC), a publicly-traded bank holding company headquartered in Hato Rey. In addition to R-G Premier, RGFC owned several other subsidiaries that engaged in banking, mortgage banking, and insurance agency-related activities. RGFC and R-G Premier shared the same Board directors.

Audit Results

Causes of Failure and Material Loss

R-G Premier failed primarily because its Board and management did not provide effective oversight of the institution and failed to react in a timely manner to deteriorating economic conditions in Puerto Rico. Problems first surfaced at the bank in 2005, when RGFC determined that certain transactions involving the transfer of mortgage loans from RGFC and its subsidiaries to other financial institutions between 2000 and 2004 had been improperly accounted for as sales and needed to be reclassified as secured financings. R-G

Premier wrote off approximately $101 million in assets during 2006 that had been generated by the purported sales, and an additional $68 million in assets were written-off in 2009. The Boards and management of RGFC and R-G Premier spent considerable time and resources addressing this matter and the problems that it caused. Despite these efforts, it took RGFC more than 2 years to revise its consolidated financial statements for the periods covered by the transactions. In addition, financial statements for subsequent years were not issued in a timely manner. The delays in issuing the financial statements reduced financial transparency, impacted R-G Premier's Call Reports, and limited the ability of RGFC and its subsidiaries to attract needed capital.

Management turnover during 2006 and 2007 presented additional disruptions, making oversight of the bank's business operations, including its lending function, problematic. During the years preceding its failure, the bank increased its exposure to ADC loans. However, the institution failed to establish and implement credit administration and related monitoring practices that were commensurate with the higher risk associated with those loans. The inadequate practices played a significant role in the loan problems that developed when the Puerto Rico real estate market deteriorated. Lax underwriting also contributed to the bank's loan problems. Further, even under the unique funding circumstances that Puerto Rico banks faced, R-G Premier's Board and management maintained a high reliance on non-core funding sources, particularly brokered deposits, to provide the bank with adequate liquidity and support its operations, including its lending activities. After the Puerto Rico economy fell into recession and the bank's asset quality deteriorated, R-G Premier's access to non-core funding sources became restricted, placing a severe strain on the bank's liquidity position.

The credit quality of R-G Premier's loan portfolio began to decline in 2007. By year-end 2008, more than 14 percent of the institution's loans were nonperforming. This negative trend continued into 2009, with the majority of problems centered in the bank's ADC loan portfolio. The provisions and losses associated with this deterioration depleted R-G Premier's earnings, eroded its capital, and strained its liquidity. OCFI closed the bank in April 2010 because it did not have sufficient capital to support its operations, and its liquidity position was severely strained.

The FDIC's Supervision of R-G Premier

The FDIC, in coordination with the OCFI, provided ongoing supervisory oversight of R-G Premier through regular on-site examinations, visitations, a targeted review, and various offsite monitoring activities. The FDIC also coordinated with representatives of the Board of Governors of the Federal Reserve System (FRB) on supervisory issues of mutual interest. Notably, in 2006, the FDIC's New York Regional Office recognized the need to closely monitor economic and banking trends in Puerto Rico. Those monitoring efforts led to the development of an integrated supervisory strategy in the fall of 2007 for all institutions operating in Puerto Rico. This broader strategy consisted of: (1) annual onsite safety and soundness examinations performed jointly with the OCFI, (2) offsite monitoring activities, and (3) targeted asset quality reviews and horizontal loan classification reviews.

Through its supervisory efforts, the FDIC identified risks in R-G Premier's operations and brought these risks to the attention of the institution's Board and management through examination reports, correspondence, and formal and informal enforcement actions. Such risks included the lack of current consolidated financial statements, the need to improve credit administration practices, and the heavy reliance on non-core funding sources. The FDIC's supervisory activities were also instrumental in implementing a well-coordinated resolution for the three failed Puerto Rico banks.

To address R-G Premier's improper accounting for mortgage loan transactions, the FDIC downgraded the bank's supervisory ratings, implemented a C&D, and coordinated with the FRB and the OCFI to conduct a review of RGFC and its affiliates for other potential safety and soundness concerns. The FDIC also monitored the bank's corrective actions thereafter. Such a supervisory response was comprehensive and consistent with the risks that the mortgage loan accounting issues presented to the bank.

At the time of the September 2005 and October 2006 examinations, the bank was increasing its ADC lending while the attention of the Board and management was focused on addressing issues pertaining to the improper accounting for mortgage loan transactions. Examiners lowered the bank's Management component rating to a "3" based, in part, on less than satisfactory risk management practices. With respect to loan underwriting and credit administration, examiners found those practices to be generally satisfactory. Further, examiners determined that the bank's capital was satisfactory but recommended in the October 2006 examination that the institution's capital plan be enhanced. While it is evident that the FDIC evaluated and monitored R-G Premier's activities in these areas, subsequent examinations found the bank's capital plan to be unsatisfactory and loan underwriting and credit administration to be inadequate.

A general lesson learned with respect to weak risk management practices is that early supervisory intervention is prudent, even when an institution is considered *Well Capitalized* and has relatively few classified assets. In this regard, stronger supervisory action, such as an informal enforcement action, to address the weak risk management practices identified during the December 2007 examination may have been prudent, considering:

- the vulnerability of CRE and ADC concentrations to economic cycles;
- the market factors in Puerto Rico that made ADC lending riskier than in other U.S. markets;
- the importance of strong underwriting and credit administration practices; and
- R-G Premier's less than satisfactory capital position for is risk profile.

Earlier supervisory intervention may have better positioned R-G Premier to work through the loan deterioration that developed as the Puerto Rico real estate market deteriorated, mitigating, to some extent, the financial problems experienced by the bank. Further, while banks in Puerto Rico faced unique challenges in attracting core deposits, earlier supervisory concern with respect to R-G Premier's heavy reliance on brokered deposits might also have been prudent. Earlier concern in this regard may have influenced R-G Premier's Board to reduce its reliance on brokered deposits, thereby reducing the bank's liquidity risk profile.

Based on the supervisory actions taken with respect to R-G Premier, the FDIC properly implemented applicable PCA provisions of section 38.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from financial institution failures during the financial crisis. With respect to the issues discussed above, the FDIC has, among other things, provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized. The FDIC has also issued supervisory guidance addressing risks associated with ADC lending and funds management practices.

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. In the response, DSC reiterated the causes of R-G Premier's failure and the supervisory activities described in our report. The response noted that the bank was unable to adequately address supervisory recommendations and enforcement measures. The response also referenced actions that DSC has taken in response to recent failures, such as issuing guidance to banks on the risks of volatile funding sources and proving training to examiners.

Contents

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 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 R-G Premier Bank of Puerto Rico, Hato Rey, Puerto Rico*
(Report No. MLR-11-009)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of R-G Premier Bank of Puerto Rico (R-G Premier), Hato Rey, Puerto Rico. The Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico (OCFI) closed the bank on April 30, 2010 and appointed the FDIC as receiver. On June 2, 2010, the FDIC notified the OIG that R-G Premier's total assets at closing were $6 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was $1.2 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 R-G Premier's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of R-G Premier, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of R-G Premier'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 MLRs, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[1]

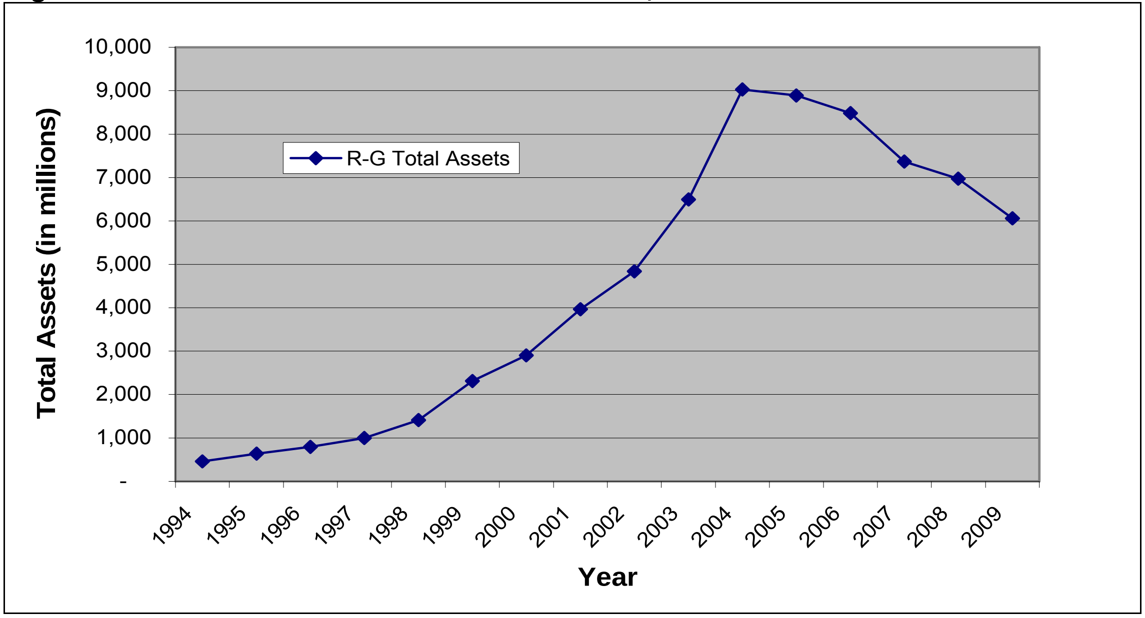
Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of key terms, including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System, otherwise known as the CAMELS ratings. Appendix 3 contains a list of acronyms. Appendix 4 provides a listing of apparent violations and contraventions of laws, rules, regulations, and policy from 2004 to 2009. Appendix 5 contains the Corporation's comments on this report.

Background

History and Description of R-G Premier

R-G Premier was established in 1983 as a federal savings bank. The FDIC became the institution's primary federal regulator in November 1994 when R-G Premier converted to a state-chartered nonmember bank. As reflected in Figure 1, R-G Premier grew its total assets from $460 million to over $9 billion between 1994 and 2004. The bank's lending activities during this period focused primarily on 1-to-4 family residential properties. From 2004 until it failed, R-G Premier experienced almost no growth in its loan portfolio and its total assets declined. In addition, the bank had a diverse loan portfolio consisting of commercial real estate (CRE) loans; acquisition, development, and construction (ADC) loans; commercial and industrial loans; and residential real estate loans. However, risk within the bank's loan portfolio increased as management began increasing the portion of the portfolio that was associated with CRE, especially ADC.

Figure 1: Trend in R-G Premier's Total Assets, 1994 to 2009



Source: OIG Analysis of data obtained from the FDIC's Institution Directory.

[1] A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of this report.

In addition to a main office in Hato Rey, R-G Premier operated 32 branches throughout Puerto Rico. The institution was wholly-owned by R&G Financial Corporation (RGFC), a publicly-traded bank holding company headquartered in Hato Rey.[2] In addition to R-G Premier, RGFC owned several other subsidiaries that engaged in banking, mortgage banking, and insurance agency-related activities. Most notably, RGFC owned R-G Mortgage Corporation, which engaged in a wide range of mortgage activities (including the securitization and sale of mortgage-backed securities), and R-G Crown Bank FSB, which was sold in November 2007. RGFC's Board Chairman, who also served as the Board Chairman of R-G Premier, controlled approximately 58 percent of the holding company's stock. The remaining stock was held by a number of other investors. RGFC and R-G Premier shared the same Board directors. Table 1 summarizes selected financial information pertaining to R-G Premier for the 6-year period ending 2009.

Table 1: Selected Financial Information for R-G Premier, 2004 to 2009

Financial Measure ($000s)	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets	6,058,499	6,969,629	7,364,202	8,481,056	8,893,411	9,029,688
Total Loans	5,433,667	5,736,184	5,356,785	5,504,306	5,814,935	5,462,926
Total Deposits	4,252,763	4,468,194	4,521,316	4,584,045	4,064,484	3,427,932
Brokered Deposits	2,107,059	2,246,372	1,937,143	1,788,807	1,330,610	714,794
ADC as Percent of Total Capital*	238	212	161	130	101	77
Net Income (Loss)	-71,311	-114,120	-3,724	32,396	96,877	80,721
Return on Average Assets	-1.09	-1.59	-0.05	0.38	1.17	1.17
Tier 1 Leverage Capital Ratio	5.53	5.84	6.37	5.83	5.27	5.22

Source: Uniform Bank Performance Reports (UBPR) for R-G Premier.
* The increase in ADC as a Percent of Total Capital during 2008 and 2009 was largely attributable to a decrease in capital. R-G Premier slowed its ADC lending in 2007, and by August 2008, was no longer originating new ADC loans.

R-G Premier was 1 of 10 banks operating in Puerto Rico before the bank was closed. Three of these 10 banks—R-G Premier, Westernbank Puerto Rico, and Eurobank, were closed on April 30, 2010.

Economic Conditions in Puerto Rico

Puerto Rico's economy has been in a severe recession for a number of years. 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 a significant increase in oil prices, budgetary pressures on government finances, and the continued loss of

[2] RGFC was regulated by the Board of Governors of the Federal Reserve System (FRB) and OCFI. As a publically traded company, RGFC was also under the jurisdiction of the Securities and Exchange Commission (SEC) and subject to certain disclosure and regulatory requirements defined in federal securities laws. In 2005, R-G Premier's total assets accounted for 66 percent of RGFC's consolidated assets. By 2009, this percentage had increased to more than 90 percent. This increase can be attributed to several factors, most notably the sale of R-G Crown Bank FSB, a subsidiary of RGFC.

manufacturing jobs. The decline in employment on the island has been acute, and the percentage of jobs lost has been nearly double that of the U.S. The unemployment rate in Puerto Rico reach 17.2 percent in April 2010, the island's highest rate in 17 years. The unemployment rate eased to 16 percent in September 2010 but remains well above the U.S rate of 9.6 percent.[3] Further, the downturn in the U.S.[4] economy has exacerbated economic conditions on the island as exports of goods to the U.S. have plummeted and tourism has declined.

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. Specifically, the Tax Reform Act of 1976 established the possessions tax credit under Section 936 of the U.S. Internal Revenue Service (IRS) code, which was enacted to encourage economic development in U.S. possessions such as Puerto Rico, the U.S. Virgin Islands, and Guam. Section 936 exempted U.S. corporations from paying federal income tax on profits generated by a qualified Puerto Rico-based 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." 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 respect to the housing sector, 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 at about the same time as it did in the U.S., but the decline has been more severe.

Funding Structure of Puerto Banks

Over the past decade, insured depository institutions in Puerto Rico became increasingly dependent on non-core funding sources, particularly brokered deposits. Between June 30, 1999 and June 30, 2009, brokered deposits increased from 13 percent to 40 percent of total deposits held by insured banks in Puerto Rico. This dependence on brokered deposits can be attributed to several factors, including the repeal of the IRS Code Section 936 and growth in Puerto Rico Investment Companies (PRICs). Section 936 essentially provided banks with low-cost corporate deposit accounts and balances. When the statute was repealed, those funds left Puerto Rico banks and were largely

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

replaced by brokered deposits. Additionally, over the past 10 years, PRICs attracted deposits away from commercial banks given their low-cost tax exempt investment products. The favorable yield, steady income stream, and capital preservation features of PRICs make them more attractive than bank deposit products.

In addition, there is significant competition among banks and "cooperativas" (state-chartered institutions similar to credit unions) for core deposits on the island. As of March 31, 2009, there were 123 "cooperativas" in Puerto Rico. Due to intense competition, local deposits tend to be priced higher than brokered deposits. Like other banks in Puerto Rico, R-G Premier was heavily dependent on brokered deposits.

Causes of Failure and Material Loss

R-G Premier failed primarily because its Board and management did not provide effective oversight of the institution and failed to react in a timely manner to deteriorating economic conditions in Puerto Rico. Problems first surfaced at the bank in 2005, when RGFC determined that certain transactions involving the transfer of mortgage loans from RGFC and its subsidiaries to other financial institutions between 2000 and 2004 had been improperly accounted for as sales and needed to be reclassified as secured financings. R-G Premier wrote off approximately $101 million in assets during 2006 that had been generated by the purported sales, and an additional $68 million in assets were written-off in 2009. The Boards and management of RGFC and R-G Premier spent considerable time and resources correcting this matter and addressing the problems that it caused. However, RGFC did not revise its consolidated financial statements for the periods covered by the transactions in a timely manner, and its financial statements for subsequent years were significantly delayed. The delays in issuing the financial statements reduced financial transparency, impacted R-G Premier's Consolidated Reports of Condition and Income (Call Reports), and limited the ability of RGFC and its subsidiaries to attract needed capital.

Management turnover during 2006 and 2007 presented additional disruptions, making oversight of the bank's business operations, including its lending function, problematic. During the years preceding its failure, the bank increased its exposure to ADC loans. However, the institution failed to establish and implement credit administration and related monitoring practices that were commensurate with the higher risk associated with those loans. The inadequate practices played a significant role in the loan problems that developed when the Puerto Rico real estate market deteriorated. Lax underwriting also contributed to the bank's loan problems. Further, R-G Premier's Board and management maintained a high reliance on non-core funding sources, particularly brokered deposits, to provide the bank with adequate liquidity and support its operations, including its lending activities. After the Puerto Rico economy fell into recession and the bank's asset quality deteriorated, R-G Premier's access to non-core funding sources became restricted, placing a severe strain on the bank's liquidity position.

The credit quality of R-G Premier's loan portfolio began to decline in 2007. By year-end 2008, more than 14 percent of the institution's loans were nonperforming. This negative trend continued into 2009, with the majority of problems centered in the bank's ADC loan portfolio. The provisions and losses associated with this deterioration depleted R-G Premier's earnings, eroded its capital, and strained its liquidity. OCFI closed the bank in April 2010 because it did not have sufficient capital to support its operations and its liquidity position was severely strained.

Board and Management Oversight

The FDIC's *Risk Management Manual of Examination Policies* (Examination Manual) states that the quality of an institution's management, including its Board and executive officers, is perhaps the single most important element in the successful operation of an institution. According to the Examination Manual, the Board has overall responsibility and authority for formulating sound policies and objectives for the institution and for effectively supervising the affairs of the institution. Executive officers, such as the President and CEO, Chief Lending Officer (CLO), and Chief Financial Officer (CFO), have primary responsibility for managing the day-to-day operations and affairs of the bank. Further, ensuring appropriate corrective actions to regulatory concerns is a key responsibility of the Board.

R-G Premier's Board and management did not provide effective oversight of the bank's operations. As described later, RGFC and it subsidiaries (including R-G Premier) did not properly account for certain mortgage loan transactions that occurred between 2000 and 2004. According to an internal bank management report, the improper accounting stemmed from material weaknesses in internal control over financial reporting, and in some cases, inappropriate conduct or insufficient supervision by certain senior management officials at RGFC and R-G Premier. In addition, RGFC did not maintain current consolidated financial statements, limiting the ability of RGFC and its subsidiaries to attract needed capital and affecting R-G Premier's submission of Call Reports.

Management turnover during 2006 and 2007 presented additional disruptions, and newly hired bank officials were not successful in addressing the bank's problems. The lack of strong management leadership made oversight of the bank's operations more problematic. As described later, a lack of Board and management oversight of the lending function and a high reliance on non-core funding sources, particularly brokered deposits, contributed to the financial problems that developed at the bank when economic conditions deteriorated in Puerto Rico. A management report prepared by an outside consultant on behalf of R-G Premier in November 2009 provided further evidence that the institution's management practices and organizational structure needed improvement. Among other things, the report recommended that the bank seek a new President and CEO, or hire an external bank turnaround consultant to advise the President and CEO on leadership and communication skills. The report also recommended that the bank re-align the roles and responsibilities of key senior bank officials, strengthen internal controls, and restructure the Board by adding new members with experience.

Accounting for Mortgage Loan Transactions and Restating Financial Statements

Between 2000 and 2004, RGFC and its subsidiaries entered into a number of privately negotiated transactions with other financial institutions in Puerto Rico to transfer pools of mortgage loans, the majority of which were originated by RGFC and/or its subsidiaries. These transactions were recorded on the books and records of RGFC and its subsidiaries as sales. However, the terms of the transactions included provision(s) wherein RGFC and/or its subsidiaries guaranteed the purchaser a specified pass-through interest rate for the loan pools. Any cash flows that were expected to be received on the mortgage loan pools above the pass-through rates (referred to herein as "residual interests")[5] were retained by RGFC and/or its subsidiaries and reflected on their books and records as both income and an asset. As of June 30, 2005, residual interests created by these transactions totaled $210 million on a consolidated holding company basis. Of this amount, $97 million was recorded on R-G Premier's balance sheet as an asset.

In addition to the residual interest described above, RGFC and its subsidiaries recognized the value of mortgage servicing rights on their books and records in connection with the transactions. Like the residual interests, the value of the mortgage servicing rights was recognized as both income and an asset. As of June 30, 2005, mortgage servicing rights generated by the transactions totaled $125 million on a consolidated holding company basis. Of this amount, $34 million was reflected on R-G Premier's balance sheet as an asset.

In 2005, RGFC determined that the mortgage loan transactions should not have been accounted for as sales under Generally Accepted Accounting Principles because, as discussed above, the transactions included a guarantee from RGFC and/or its subsidiaries. Instead, the transactions should have been recorded as secured financings.[6] As a result, R-G Premier was required to unwind the transactions by repurchasing the mortgage loan pools from the institutions that acquired them and eliminating the gains and assets created by the transactions. R-G Premier wrote off approximately $101 million in residual interest and mortgage servicing rights when it reversed the transactions. Although this amount was not significant enough to lower the bank's PCA capital category below *Well Capitalized*, it reduced the bank's capital and negatively affected earnings.

R-G Premier wrote off an additional $68 million in assets during 2009 stemming from how it accounted for mortgage loan transactions. These write-offs consisted of (1) accounts receivable created when RGFC's consolidated financial statements were restated that reflected the value of mortgage servicing rights transferred from R-G Premier to its affiliates without compensation and (2) deferred tax assets (DTA) transferred from RGFC to R-G Premier in 2008 as partial payment for the accounts

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[5] The majority of the residual interests were recorded as "Interest/Only strips."

[6] Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS 140), distinguishes transfers of financial assets that are "true sales" from transfers that are secured borrowings. A transfer is considered a true sale when all of the following conditions are met: (1) the assets have been isolated from the transferor; (2) the transferee has the right to pledge or exchange the assets; and (3) the transferor is not obligated to repurchase the assets before maturity or does not have the ability to cause the transferee to return the assets.

receivable. Examiners determined that R-G Premier's affiliates did not have the financial wherewithal to pay the accounts receivable, and it was uncertain whether or when the bank could use the DTAs. After adjusting capital to reflect the $68 million in write-offs and additional provision expenses identified by examiners, the bank fell to *Adequately Capitalized*.

The Boards and management of RGFC and R-G Premier spent considerable time and resources working to restate the company's consolidated financial statements for the years ended 2002 through 2004.[7] However, revised financial statements were not issued until November 2007. According to examination records we reviewed, R-G Premier's President and CEO indicated that the primary reason for the delays in the restatement process was "back and forth" negotiations between the bank and its independent accounting firm regarding the language that would be included in the explanatory notes to the financial statements. Although R-G Premier continued to file its quarterly Call Reports while RGFC worked to reissue its financial statements, the reports included estimates because final figures could not be reported until the restatement effort was complete. R-G Premier filed amended Call Reports on June 27, 2008 to reflect final figures for the years ended 2002 through 2004. Because of the effort devoted to the restatement process, RGFC did not issue consolidated financial statements for 2005 through 2007 until June 2009. At that time, RGFC's independent accounting firm resigned and RGFC engaged a new accounting firm. RGFC issued consolidated financial statements for 2008 in February 2010 and did not issue consolidated financial statements for 2009.

The issues pertaining to the improper accounting of mortgage loan transactions and the protracted process for issuing revised consolidated financial statements had a negative impact on R-G Premier. A brief summary follows.

- **Financial Impact.** As previously stated, R-G Premier wrote off assets totaling $101 million and $68 million in 2006 and 2009, respectively, which reduced the bank's earnings and capital. In addition, the bank incurred legal, accounting, and other overhead costs to correct the improper accounting, unwind the transactions, and respond to shareholder lawsuits, an SEC investigation, and actions from regulatory authorities. Further, the lack of financial transparency caused by RGFC's inability to issue timely consolidated financial statements limited the ability of RGFC and its subsidiaries to attract needed capital.[8] Consequently, RGFC was not able to serve as a source of financial strength to the bank.

- **Management Impact.** R-G Premier Board minutes that we reviewed stated that the bank's management had not provided proper attention to important risk

[7] Although RGFC and its subsidiaries improperly recorded certain mortgage loan transactions as sales between 2000 and 2001, the correction of these transactions was reflected through adjustments in the revised 2002 consolidated financial statements in lieu of re-issuing new financial statements for 2000 and 2001.

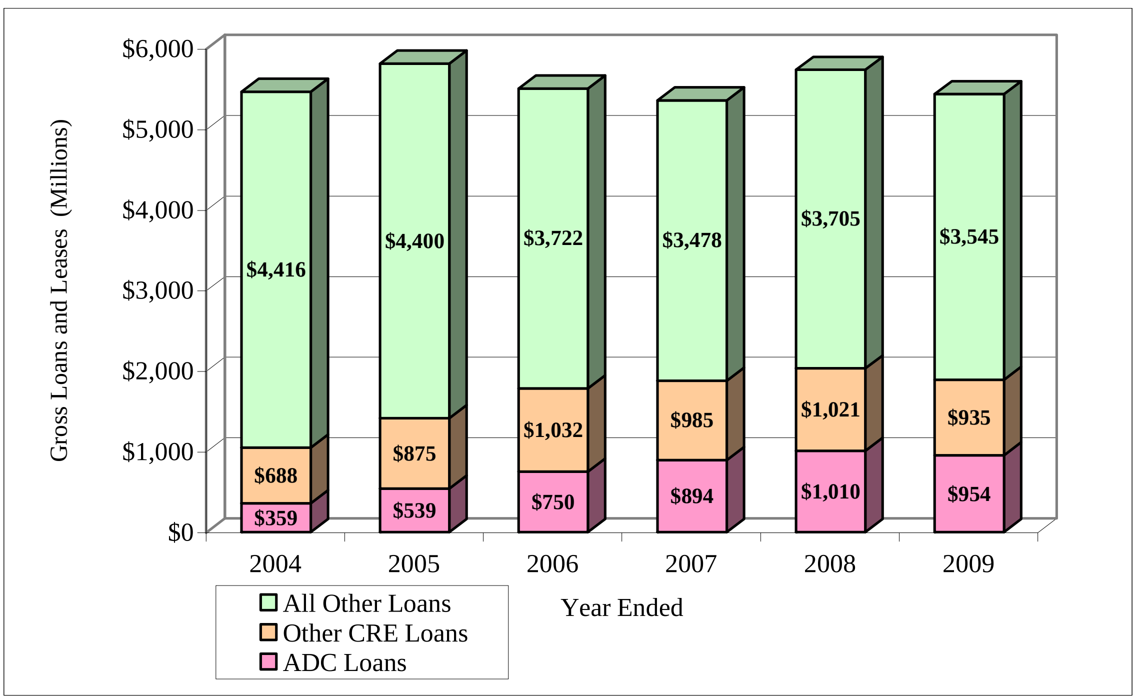
[8] RGFC's common stock was delisted (i.e., removed from trading) from the New York Stock Exchange (NYSE) on February 22, 2007, after the company failed to comply with the NYSE's reporting requirements. By November 2007, the company's stock was quoted on the Pink Sheets at less than $1 per share, down from about $40 per share in December 2004.

management concerns at the bank because of the efforts to restate RGFC's consolidated financial statements. Further, the resignation or removal of several senior bank officials in connection with the accounting issues presented additional disruptions. In January 2006, R-G Premier's Board accepted the resignation of both the President and the CFO of the bank and terminated an Executive Vice President. In addition, R-G Premier's Board Chairman and CEO resigned in 2007. The individuals that replaced these officials were not successful in addressing the bank's problems.

ADC Lending

Prior to 2004, R-G Premier's lending activities focused primarily on the financing of 1-to-4 family residential properties. In 2004, the bank's management made a strategic shift in its lending strategy and began increasing the portion of its loan portfolio that was associated with ADC. Generally, R-G Premier's ADC lending focused on residential construction and development projects in Puerto Rico. As reflected in Figure 2, R-G Premier's ADC loans increased from $359 million (or 7 percent of total loans) to more than $1 billion (or 18 percent of total loans) between 2004 and 2008, respectively. The majority of the bank's ADC loans were originated prior to 2007. ADC loan growth in 2007 and 2008 was largely attributed to loan commitments associated with prior originations, as well as new loan originations. Although the bank's total loans did not increase between 2004 and 2008, the credit risk profile of the bank's loan portfolio was increasing due to the risky nature of ADC loans.

Figure 2: Composition and Growth of R-G Premier's Loan Portfolio



Source: OIG analysis of Call Reports for R-G Premier.

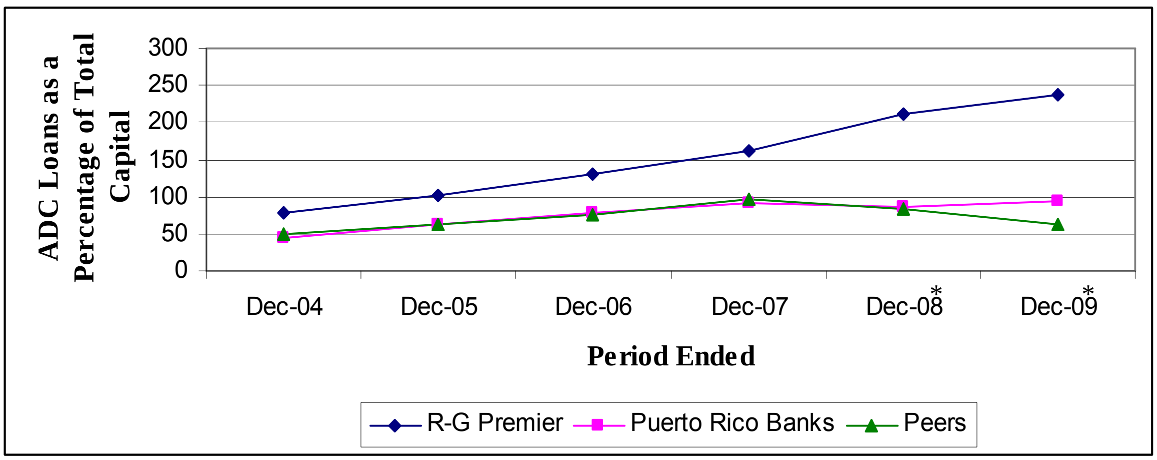
In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the FRB issued joint guidance, entitled, *Concentrations in Commercial Real Estate Lending,* *Sound Risk Management Practices* (Joint Guidance). Although the Joint Guidance does not establish specific limits for CRE and ADC lending, it does define criteria that the agencies use to identify institutions potentially exposed to significant CRE and ADC concentration risk. According to the Joint Guidance, an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- Total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or

- Total loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of total capital.

Figure 3 illustrates the trend in R-G Premier's ADC loan concentration relative to total capital as compared to all insured banks in Puerto Rico and the bank's peer group. As reflected in the figure, the bank's exposure to ADC loans met the criteria defined in the Joint Guidance as possibly warranting further supervisory analysis at the time the guidance was issued. In addition, R-G Premier's ADC concentration was higher than the average of other banks in Puerto Rico and banks in R-G Premier's peer group.[9]

Figure 3: Trend in R-G Premier's ADC Loan Concentration Compared to Other Puerto Rico Banks and Peer Group



Source: OIG Analysis of UBPRs for R-G Premier and ADC concentration data for all insured commercial banks in Puerto Rico.
* The increase in R-G Premier's ADC loans relative to total capital is largely attributable to the bank's declining capital levels.

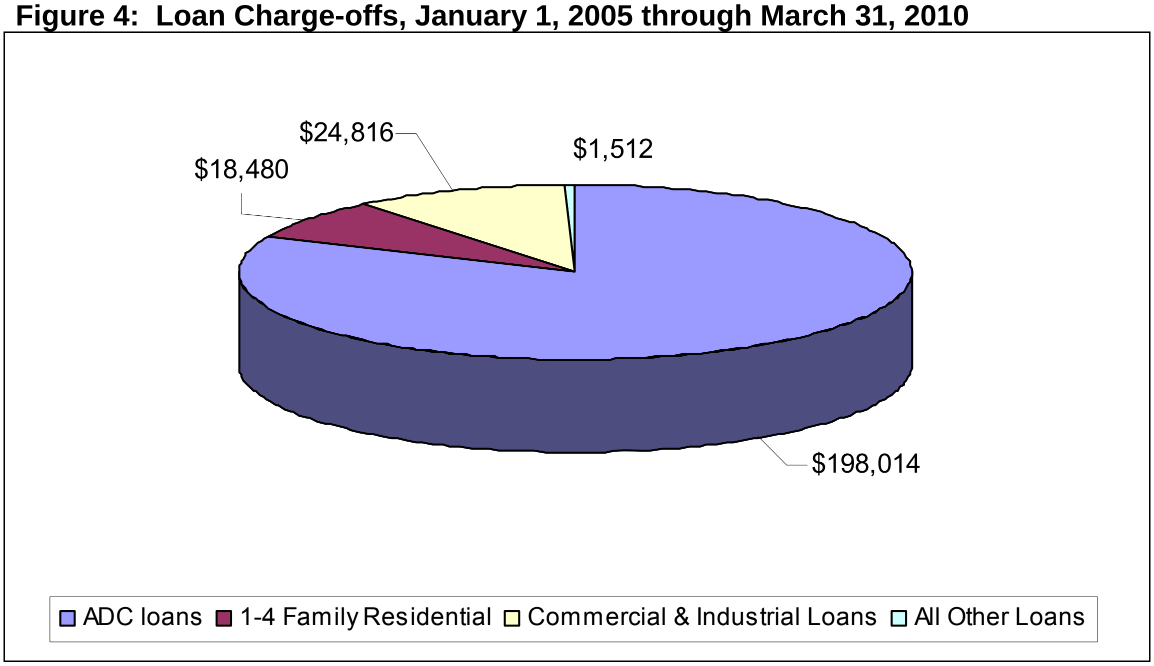
ADC lending generally involves a greater degree of risk than permanent financing for finished residences or commercial buildings. These risks include adverse changes in market conditions between the time an ADC loan is originated and the time construction

[9] 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. R-G Premier's peer group included insured commercial banks having assets between $1 billion and $3 billion.

is completed, as well as the inherent difficulty of accurately estimating the cost of construction and the value of completed properties in future periods. Due to these and other risk factors, ADC loans generally require a greater level of effort to effectively evaluate and monitor than other types of loans. Adding to the risks associated with R-G Premier's ADC loans were characteristics of ADC lending that were unique to Puerto Rico. Such characteristics included longer timeframes for construction projects as compared to construction projects in the U.S. and the inability of Puerto Rico developers to enter into long-term, pre-sale contracts with non-refundable deposits.

At the time of the December 2007 examination, R-G Premier's adversely classified assets totaled approximately $261 million, or 42 percent of Tier 1 Capital plus the Allowance for Loan and Lease Losses (ALLL). While the majority of these classifications were not ADC, examiners noted emerging problems in the bank's ADC loan portfolio. By the February 2009 examination, adversely classified assets had jumped to almost $1.2 billion, or 183 percent of Tier 1 Capital plus the ALLL. The majority of these classifications were centered in CRE loans, which included ADC loans.[10] By the end of 2009, almost 22 percent of R-G Premier's $5.3 billion loan portfolio was non-performing. Further, about 54 percent of the bank's ADC loan portfolio was non-performing at that time. As reflected Figure 4, the majority of loan charge-offs between January 1, 2005 and March 31, 2010 pertained to ADC loans. This is notable since ADC loans represented less than 20 percent of the bank's total loan portfolio at the end of 2009.

Figure 4: Loan Charge-offs, January 1, 2005 through March 31, 2010



Source: Call Reports for R-G Premier.

[10] Of the $1.2 billion in classified assets, $138 million were classified loss. Almost half of the loss pertained to the accounts receivable created during the financial restatement process and the DTAs transferred to R-G Premier in 2008 as partial payment for the accounts receivable.

Oversight of the Lending Function

Ineffective Board and management oversight of the lending function contributed to the asset quality problems that developed at R-G Premier when economic conditions deteriorated in Puerto Rico. During the December 2007 examination, and more prevalently during the February 2009 examination, examiners noted weaknesses in the bank's loan underwriting, administration, and related monitoring practices. Generally, these weaknesses became more pronounced as the Puerto Rico real estate market deteriorated. In addition, an asset valuation review performed on behalf of the FDIC's Division of Resolutions and Receiverships (DRR) in early 2010 found that the bank's loan portfolio exhibited weak loan underwriting, administration, and related monitoring. A brief description of some of the more salient weaknesses in R-G Premier's lending function follows.

- **Financial Analysis.** Some common deficiencies evident in loan files included a lack of current financial statements, limited analysis of debt service coverage, and a lack of global cash flow analysis. In addition, construction loan files often lacked important documents such as current financial statements, project plans, and feasibility studies. Generally, loan underwriting, particularly with respect to renewals, focused on the appraised value of the collateral and the guarantor's financial strength.

- **Appraisals.** Appraisal reviews were not always commensurate with the risk, size, and complexity of the underlying loans. In addition, the bank did not ensure that appraisers' methods, assumptions, and conclusions were reasonable and appropriate for the transaction and property. In some cases, the bank did not compare actual market absorption rates to anticipated absorption rates in the appraisal or relied on outdated appraisals when extending or renewing loans. Further, the February 2009 examination report cited numerous apparent appraisal violations. See Appendix 4 for information regarding apparent violations and contraventions cited by examiners in examination reports.

- **Loan Renewals, Extensions, and Modifications.** R-G Premier frequently renewed, extended, or modified loans without taking adequate steps to ensure that the borrower had the capacity to repay the loan or without identifying viable exit strategies. In some cases, the renewals, extensions, and modifications may have masked loan problems.

- **Interest Reserves.** Management sometimes created interest reserves for loans that were not granted for construction purposes (i.e., land loans) and utilized other construction funds to make interest payments when interest reserves were fully utilized. Further, the bank did not properly track interest reserves.

- **Construction Monitoring.** R-G Premier did not establish a process for effectively monitoring and supervising construction and land acquisition projects. Among other things, many ADC loans did not have draw files to track the progress of construction and funding.

- **Borrower Equity.** The bank financed projects for which the borrowers had little to no equity in the project. Frequently, construction loans were based on the bank receiving a percentage of the sales price once units were sold. As a result, the bank had little protection in the event that real estate projects did not sell as originally estimated.

- **Internal Loan Review and Grading.** The bank's internal loan review and grading process did not identify problem loans in a timely manner. For example, examiners downgraded 36 loans totaling approximately $230 million during the February 2009 examination that had not been properly graded by the bank's internal loan review process.

- **Portfolio Stress Testing.** R-G Premier did not conduct stress testing of its loan portfolio to determine the impact that various economic scenarios might have on the institution's asset quality, capital, earnings, and liquidity as recommended in the Joint Guidance. The lack of stress testing limited the institution's ability to effectively assess its exposure to a downturn in the Puerto Rico real estate market.

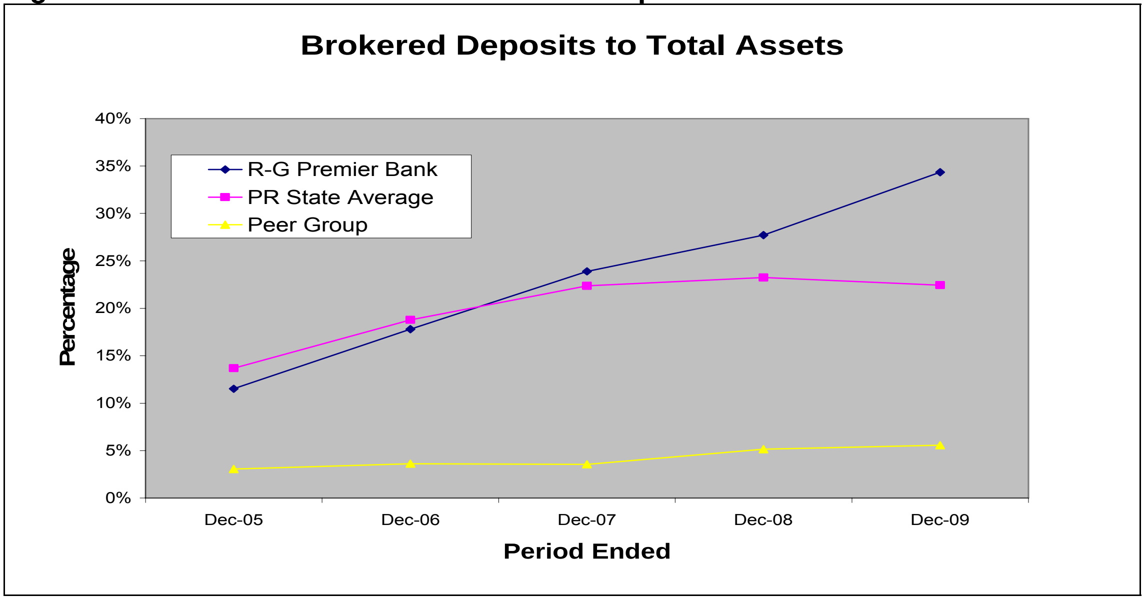
- **Allowance for Loan and Lease Losses.** R-G Premier's ALLL methodology did not comply with the December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses* in the years preceding its failure. As a result, the bank did not make sufficient provisions to its ALLL, which resulted in overstated earnings and capital. For example, the February 2009 examination report concluded that the bank's ALLL was underfunded by $29 million. In addition, a targeted asset quality review (TAQR) completed by the FDIC in December 2009 found that the bank's flawed ALLL methodology had contributed to a $227.8 million underfunded ALLL.

Reliance on Non-Core Funding

Even under the unique funding circumstances that Puerto Rico banks faced, R-G Premier maintained a high reliance on non-core funding sources, particularly brokered deposits, to provide the bank with adequate liquidity and support its operations, including its lending activities.[11] As reflected in Figure 5, R-G Premier's ratio of brokered deposits to total assets trended higher as compared to other institutions in Puerto Rico and the bank's peer group for the 5-year period ended 2009. In addition, the bank's ratio of brokered deposits to total assets was higher than the average of other banks in Puerto Rico beginning in 2007. During this same period, R-G Premier's reliance on other non-core funding sources, such as Federal funds purchased and other borrowings, declined. Management determined that brokered deposits were more cost-effective and expeditious to acquire than growing deposits through the institution's branch network.

[11] See the Background section of this report for an explanation regarding why banks in Puerto Rico were generally more dependent on brokered deposits than banks in the U.S.

Figure 5: Trend in R-G Premier's Brokered Deposits Relative to Total Assets



Source: OIG Analysis of UBPRs for R-G Premier and other banks in Puerto Rico.

When properly managed, brokered deposits offer a number of important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags planned asset growth. However, brokered deposits also present potential risks, such as increased volatility when interest rates change and statutory restrictions when the credit risk profile of an institution deteriorates. Under distressed financial or economic conditions, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

In March 2006, the FDIC and OCFI issued a Cease and Desist Order (C&D) requiring, among other things, that R-G Premier develop a written liquidity plan. Although the bank developed such a plan, it did not specifically address circumstances under which the bank's access to brokered deposits might become restricted. Between the end of 2006 and the end of 2008, R-G Premier's brokered deposits increased from approximately $1.8 billion (or 39 percent of total deposits) to over $2.2 billion (or 50 percent of total deposits).[12] During 2009, the bank experienced a significant decline in its asset quality that limited its access to external sources of liquidity. In addition, the bank's liquid assets (defined as investment securities, trading account assets, interest bearing balances, and cash) as a percent of total assets were declining.

On August 3, 2009, the OCFI formally notified the Board of R-G Premier that, based on the results of the February 2009 examination, the institution had fallen to *Adequately Capitalized* for purposes of PCA. As a result, the institution was prohibited from accepting, renewing, or rolling over brokered deposits without first seeking a waiver from the FDIC. Given the bank's heavy reliance on brokered deposits, an inability to access this funding source would trigger a near-term liquidity crisis. In October 2009, the FDIC granted a brokered deposit waiver that allowed the bank to accept, renew, and roll over up to 75 percent of the brokered deposits on the bank's balance sheet through January

[12] During this same time period, R-G Premier was experiencing a decrease in its core deposits.

2010. In February 2010, the FDIC extended the brokered deposit waiver through April 30, 2010. On April 27, 2010, the FDIC formally notified the institution that it had fallen to *Significantly Undercapitalized* and was no longer permitted to accept, renew, or roll over brokered deposits. The OCFI closed R-G Premier 3 days later.

The FDIC's Supervision of R-G Premier

The FDIC, in coordination with the OCFI, provided ongoing supervisory oversight of R-G Premier through regular on-site examinations, visitations, a targeted review, and various offsite monitoring activities. The FDIC also coordinated with representatives of the FRB on supervisory issues of mutual interest. Notably, in 2006, the FDIC's New York Regional Office (NYRO) recognized the need to closely monitor economic and banking trends in Puerto Rico. Those monitoring efforts led to the development of an integrated supervisory strategy in the fall of 2007 for all institutions operating in Puerto Rico. This broader strategy consisted of: (1) annual on-site safety and soundness examinations performed jointly with the OCFI, (2) offsite monitoring activities, and (3) TAQRs and horizontal loan classification reviews.

Through its supervisory efforts, the FDIC identified risks in R-G Premier's operations and brought these risks to the attention of the institution's Board and management through examination reports, correspondence, and formal and informal enforcement actions. Such risks included the lack of current consolidated financial statements and Call Reports, the need to improve credit administration practices in light of the weakening economy, and a heavy reliance on non-core funding sources. The FDIC's supervisory activities were also instrumental in implementing a well-coordinated resolution of R-G Premier, Westernbank Puerto Rico, and Eurobank.

To address R-G Premier's improper accounting for mortgage loan transactions, the FDIC downgraded the bank's supervisory ratings, implemented a C&D, and coordinated with the FRB and the OCFI to conduct a review of RGFC and its affiliates for other potential safety and soundness concerns. The FDIC also monitored the bank's corrective actions thereafter. Such a supervisory response was comprehensive and consistent with the risks that the mortgage loan accounting issues presented to the bank.

At the time of the September 2005 and October 2006 examinations, the bank was increasing its ADC lending while the attention of the Board and management was focused on addressing issues pertaining to the improper accounting for mortgage loan transactions. Examiners lowered the bank's Management component rating to a "3" based, in part, on less than satisfactory risk management practices. With respect to loan underwriting and credit administration, examiners found those practices to be generally satisfactory. Further, examiners determined that the bank's capital was satisfactory but recommended in the October 2006 examination that the institution's capital plan be enhanced. While it is evident that the FDIC evaluated and monitored R-G Premier's activities in these areas, subsequent examinations found the bank's capital plan to be unsatisfactory and loan underwriting and credit administration to be inadequate.

A general lesson learned with respect to weak risk management practices is that early supervisory intervention is prudent, even when an institution is considered *Well Capitalized* and has relatively few classified assets. In this regard, stronger supervisory action, such as an informal enforcement action, to address the weak risk management practices identified during the December 2007 examination may have been prudent. Earlier supervisory intervention may have better positioned R-G Premier to work through the loan deterioration that developed as the Puerto Rico real estate market deteriorated, mitigating, to some extent, the financial problems experienced by the bank.

Further, while banks in Puerto Rico faced unique challenges in attracting core deposits, earlier supervisory concern with respect to the bank's heavy reliance on brokered deposits to support its operations (including lending) might have been prudent. Earlier concern in this regard may have influenced R-G Premier's Board to reduce its dependency on brokered deposits, thereby reducing the bank's liquidity risk profile.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from financial institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized. The FDIC has also issued supervisory guidance addressing risks associated with ADC lending and funds management practices.

Supervisory History

The FDIC and OCFI conducted a total of five on-site risk management examinations, one visitation, and one targeted review of R-G Premier between 2004 and the bank's failure. Table 2 summarizes key supervisory information pertaining to these supervisory activities.

Table 2: On-site Examinations, Visitation, and Targeted Review of R-G Premier

Examination Start Date	Type of Examination	Regulator	Supervisory Ratings	Informal or Formal Action Taken***
11/16/2009	TAQR	FDIC/OCFI	554553/5	C&D Remained in Effect
2/23/2009	Risk Management	FDIC/OCFI	444543/4	Amended C&D Effective October 23, 2009
12/28/2007	Risk Management	FDIC/OCFI	333322/3	C&D Remained in Effect
8/15/2007	Visitation*	FDIC	NA	C&D and BBR Remained in Effect
10/30/2006	Risk Management	FDIC/OCFI	223322/2	C&D Remained in Effect; BBR effective August 7, 2007
9/12/2005	Risk Management	FDIC/OCFI	223223/2**	C&D effective March 16, 2006
7/28/2004	Risk Management	FDIC/OCFI	112111/1	MOU effective December 8, 2004

Source: OIG analysis of examination reports and information in the FDIC's Virtual Supervisory Information on the Net system for R-G Premier.
* The purpose of the visitation was to assess the bank's subprime lending and nontraditional mortgage activities.
** The FDIC issued an interim ratings downgrade during the examination to 323233/3 based on the bank's improper accounting for mortgage loan transactions. The downgrade became effective February 22, 2006. Prior to the completion of the examination, the FDIC revised the bank's ratings to 223223/2.
*** Informal enforcement actions often take the form of Bank Board Resolutions (BBR) or Memoranda of Understanding (MOU). Formal enforcement actions often take the form of C&Ds but under severe circumstances can also take the form of insurance termination proceedings.

In addition to the examinations, visitation, and TAQR described in Table 2, the FDIC, the FRB, and the OCFI conducted an on-site coordinated review of the operations of RGFC and its affiliates in April 2006. The purpose of the review was to determine whether there were any material safety and soundness weaknesses associated with the mortgage banking business of RGFC and its affiliates.

Informal and Formal Actions

As reflected in Table 2, the FDIC, in coordination with OCFI, implemented several formal and informal enforcement actions to address safety and soundness concerns at the bank in the years preceding its failure. A brief description of these actions follows.

- **December 8, 2004 MOU.** The purpose of the MOU was to address extensive and persistent weaknesses in the bank's Bank Secrecy Act (BSA)/Anti Money Laundering (AML) program.

- **March 16, 2006 C&D.** The purpose of the C&D was to address safety and soundness concerns pertaining to the bank's improper accounting for certain mortgage loan transactions, the majority of which were consummated between 2002 and 2004. Among other things, the C&D required the bank to engage an independent consultant to conduct a comprehensive review of the institution's mortgage loan activities and related accounting practices; submit capital and liquidity plans; obtain prior regulatory approval for dividend payments and affiliate transactions; and promptly correct its Call Reports. RGFC entered into a similar agreement with the FRB in March 2006.

- **August 7, 2007 BBR.** The purpose of the BBR was to address various weaknesses in the bank's BSA/AML program.

- **October 23, 2009 Amended C&D.** The purpose of this C&D was to amend the March 16, 2006 C&D to include provisions for addressing safety and soundness deficiencies identified during the February 2009 examination. Among the new provisions was a requirement for the bank to maintain capital ratios above the minimum thresholds for *Well Capitalized* institutions.

The formal and informal actions described above required R-G Premier to provide the FDIC and OCFI with periodic progress reports describing the bank's remedial actions.

Offsite Monitoring

The FDIC's offsite monitoring procedures generally consisted of using automated tools[13] to help identify potential supervisory concerns and contacting the bank's management from time to time to discuss current and emerging issues and ongoing efforts to address regulatory concerns. R-G Premier appeared on the FDIC's Offsite Review List[14] six times between June 2007 and June 2009, principally because of the growing deterioration in the bank's ADC loan portfolio. The FDIC coordinated the results of its offsite monitoring with its on-site examination activities. In mid-2007, the FDIC identified a general deterioration in the financial condition of banks in Puerto Rico caused by a decline in the local economy. In response to this deterioration, the FDIC formulated an integrated supervisory strategy for all institutions operating in Puerto Rico. A description of this strategy follows.

Supervisory Strategy for Puerto Rico

In March 2006, the NYRO Regional Risk Committee (RRC)[15] 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;

[13] The FDIC uses various offsite monitoring tools to help assess the financial condition of institutions. Two such tools are the Statistical CAMELS Offsite Rating system and the Growth Monitoring System. Both tools use statistical techniques and Call Report data to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources.
[14] The Offsite Review List identifies institutions warranting heightened supervisory oversight.
[15] FDIC's policy requires that each region have an RRC.

- 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 in March 2006, 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, among other things, four consecutive quarters of job losses. 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 increasing provision expenses associated with a deterioration in asset quality. At the time, the NYRO was particularly concerned about the potential risks associated with consumer loans.

Specifically, 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. Between 2004 and 2009, the national median past-due ratio for consumer loans ranged from a low of 1.65 percent at year-end 2006 to a high of 1.97 percent at year-end 2009. During the same time period, 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 order to identify institutions with concentrations above supervisory thresholds defined in the Joint Guidance issued in December 2006. Concentrations were of heightened concern because Puerto Rico had lost jobs for more than two consecutive quarters, which may have been indicative of a recession. Further, the deteriorating trend showed signs of continuing.

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 Improper Accounting and Reporting for Mortgage Loan Transactions

The FDIC's supervisory response with respect to the improper accounting and reporting for mortgage loan transactions was comprehensive and consistent with the risks that these issues presented to the bank. Examiners first noted concerns pertaining to R-G Premier's mortgage loan accounting and reporting during the September 2005 examination. Examiners held the examination open until late 2006 to fully assess the risks associated with this matter. A brief summary of the more salient actions taken by the FDIC during the September 2005 examination to address the mortgage loan accounting and reporting issues follows.

- **Ratings Downgrade.** The FDIC downgraded the bank's ratings on an interim basis from 112111/1 to 323233/3 in February 2006. Based on the remedial actions taken by the bank to address the mortgage loan accounting and reporting issues, the FDIC raised the bank's ratings to 223223/2 at the conclusion of the examination.

- **C&D.** The FDIC implemented a C&D in March 2006. Among other things, the C&D required the bank to engage an independent consultant to conduct a comprehensive review of the institution's mortgage loan activities and related accounting practices; develop a written capital plan to ensure adequate capital was maintained by the bank in light of the reclassification of any mortgage portfolio; develop a written plan for the maintenance of adequate liquidity; obtain prior regulatory approval for dividend payments and affiliate transactions; and promptly correct Call Reports. RGFC entered into a similar agreement with the FRB in March 2006.

- **Interagency Review.** The FDIC, the FRB, and the OCFI conducted an on-site, coordinated review of the operations of RGFC and its affiliates in April 2006. The purpose of the review was to identify potential safety and soundness weaknesses associated with the mortgage banking business of RGFC and its subsidiaries. The review found that the unwinding of several mortgage loan transactions had led to apparent violations of Sections 23A and 23B of the Federal Reserve Act. Specifically, when the bank repurchased certain mortgage loans, it assumed low quality assets to the benefit of an affiliate and relieved RGFC and another affiliate of certain guarantees without compensation to the bank.

- **Monitoring.** The FDIC monitored the remedial efforts of R-G Premier and its parent company through status reports required by the C&D and on-site and offsite supervisory activities.

The October 2006 examination report stated that although RGFC and R-G Premier had taken a number of actions to correct the problems resulting from the reclassification of the mortgage loan transactions, additional remedial action was required. Specifically, RGFC needed to complete the restatement of its consolidated financial statements so that R-G Premier could file amended prior period Call Reports. In addition, some of the bank's reclassified mortgage loan transactions had not yet been unwound. Examiners also recommended that the bank enhance its capital and liquidity plans required by the March 2006 C&D. Management officials advised examiners that the financial restatement effort had sometimes impaired management's ability to address deficiencies in the bank's operations. Examiners assigned a Management component rating of "3" during the examination due do management's less than satisfactory performance.

The December 2007 examination report noted that the bank had substantially completed its efforts to unwind the mortgage loan transactions and that RGFC had restated its consolidated financial statements for the periods 2002 through 2004. In addition, Call Report amendments for 2002 through 2004 had been filed in June 2008. However, consolidated financial statements for 2005 through 2007 had not yet been issued, and the bank was continuing to use estimated figures in its Call Reports for these periods.

According to examination records that we reviewed, R-G Premier's President and CEO indicated that the primary reason for the delays in the restatement process was "back and forth" negotiations between the bank and its independent accounting firm regarding the language that would be included in the explanatory notes to the financial statements. In addition, Division of Supervision and Consumer protection (DSC) examiners advised us that the bank's auditors experienced difficulties working with the institution's information systems, which contributed to the prolonged restatement process. Apparent violations of Sections 23A and 23B of the Federal Reserve Act were also cited in connection with the unwinding of the transactions.

Examiners further determined during the December 2007 examination that the bank's capital was less than satisfactory due to the ongoing deterioration in the loan portfolio, weak earnings, lack of current consolidated financial statements, and the poor financial condition of RGFC. The examination report noted that the bank's capital plan was broad in nature and dependent on RGFC's ability to serve as a source of financial strength. Examiners again assigned a Management component rating of "3" due to management's continued lack of satisfactory performance and downgraded the bank's composite rating to a "3."

The February 2009 examination report noted that RGFC had issued consolidated financial statements for the years 2005 through 2007, but that consolidated financial statements for 2008 had not yet been issued. In addition, the bank had not amended its Call Reports since, and including, the December 31, 2005 report. Examiners also noted instances in which regulatory approvals were not requested or obtained prior to entering into certain affiliate transactions, which resulted in apparent violations of Sections 23A and 23B of the Federal Reserve Act. Further, examiners determined that the bank's capital was deficient and that the bank either needed to raise new capital or find an acquirer. Examiners downgraded both the Management component and composite ratings to a "4."

With respect to R-G Premier's filing of Call Reports, examiners appropriately noted their concerns in examination reports and such concerns were included in the March 2006 C&D. According to examination reports, R-G Premier continued to regularly file Call Reports while RGFC worked to complete the financial restatement process. The Call Reports included estimated figures to reflect the adjustments that management expected would be required as a result of the improper accounting for the mortgage loan transactions. Examiners advised us that the estimated figures were not found to be materially inaccurate.

Supervisory Response to ADC Lending Risks

As previously discussed, at the time of the September 2005 and October 2006 examinations, the bank was placing emphasis on ADC lending and the attention of the Board and management was focused on addressing issues pertaining to the improper accounting for mortgage loan transactions. Further, R-G Premier's ADC loans had certain risk characteristics that were unique to Puerto Rico, such as longer timeframes for construction projects than in the U.S. During those examinations, R-G Premier's adversely classified assets were at manageable levels, and examiners found the institution's ADC lending practices to be generally satisfactory. In addition, examiners determined that the bank's capital was satisfactory, but recommended in the October 2006 examination that the capital plan be enhanced to describe how the bank would attract additional sources of capital and how the bank's capital ratios might be impacted by the various scenarios described in the plan.

During the December 2007 examination, examiners determined that the bank's loan underwriting and credit administration practices were generally adequate, but that they were not consistent throughout the bank until recently. For example, examiners noted that although the bank's credit policies were satisfactory, management approved many policy exceptions on a loan-by-loan basis without a mechanism to track the aggregate level or materiality. In addition, the Loan Department structure had not previously provided for separation of duties in such areas as appraisal order and review or credit risk analysis. Examiners made a number of recommendations during the December 2007 examination to improve the bank's controls pertaining to the lending function and its risk monitoring practices. Among other things, examiners recommended that the bank strengthen its documentation of underwriting analysis and ongoing supervision of participation loans, enhance its methodologies for calculating loan-to-value ratios and monitoring adherence to regulatory guidelines for real estate lending, establish loan concentration limits, and develop a strategic plan that would address the impact and planned actions of further potential market declines.

The December 2007 examination report also noted that although the bank was *Well Capitalized*, substantial contingencies existed which could negatively affect the bank's capital ratios. Such contingencies included a further decline in the quality of the bank's assets and the results of the financial restatement process. The examination report also stated that the bank's capital plan was broad in nature and dependent on RGFC to serve as a source of financial strength. However, as noted in the examination report, RGFC had well-publicized problems at that time and was not a source of financial strength to

R-G Premier. In addition, examiners noted that the economic downturn in Puerto Rico was negatively affecting the performance of the bank's loans, particularly its ADC loans, and downgraded the bank's Asset quality, Capital, and composite ratings to a "3."

By the February 2009 examination, R-G Premier's adversely classified assets totaled almost $1.2 billion, or 183 percent of the bank's Tier 1 Capital plus the ALLL. Almost 90 percent of these classifications consisted of loans, the majority of which were ADC loans. Examiners that we spoke with indicated that weak loan administration practices were a particularly significant factor in the decline of the bank's loan quality. Examiners also noted that the bank failed to promptly recognize ADC loan problems and losses as they became apparent and extended or renewed troubled ADC loans without adequate financial analysis, including obtaining quality appraisals, when the Puerto Rico real estate market declined. In addition, the February 2009 examination report stated that the loan deterioration was attributed to liberal lending practices on construction and land development loans, coupled with lax underwriting and credit administration weaknesses, all of which were exacerbated by the depressed real estate market and economy in Puerto Rico. The examination report added that from 2005 through 2007, management was focused on growing the CRE portfolio, particularly the construction and land loan portfolio, without concern for satisfactory underwriting.

Based on the results of the February 2009 examination, examiners downgraded the bank's Asset quality, Capital, and composite ratings to a "4" and issued an amended C&D in October 2009 to address the deficiencies identified during the examination. The FDIC identified further substantial deterioration in R-G Premier's financial condition during the November 2009 TAQR. Specifically, the bank's ALLL methodology and loan impairment analyses were flawed, resulting in a shortfall in the ALLL by approximately $228 million. Based on the preliminary results of the TAQR, the FDIC downgraded the bank's composite rating to a "5" effective December 4, 2009.

Supervisory Lessons Learned

Examiners considered R-G Premier's management performance to be less than satisfactory during the September 2005 examination and lowered the component rating for Management to a "3." Management never received a satisfactory rating thereafter based, in part, on less than satisfactory risk management practices. With respect to the bank's loan underwriting and credit administration, examiners found practices in those areas to be generally satisfactory during the September 2005 and October 2006 examinations. Further, examiners determined that the bank's capital was satisfactory during those examinations but recommended in the October 2006 examination that the institution's capital plan be enhanced. While it is evident that the FDIC evaluated and monitored R-G Premier's activities in these areas, subsequent examinations found the bank's capital plan to be unsatisfactory and loan underwriting and credit administration to be inadequate.

A general lesson learned with respect to weak risk management practices, particularly as they relate to lending activities in general and ADC concentrations in particular, is that early supervisory intervention is prudent, even when an institution is considered *Well*

Capitalized and has relatively few classified assets. While the FDIC downgraded the bank's Asset quality, Capital, and composite ratings to a "3" during the December 2007 examination, stronger supervisory action to address the weak risk management practices identified by examiners may have been prudent considering such factors as:

- the vulnerability of CRE and ADC concentrations to economic cycles;
- the market factors that made ADC lending in Puerto Rico riskier than in other U.S. markets;
- the importance of strong underwriting and credit administration practices to mitigate risk, particularly in a weakening economy; and
- R-G Premier's less than satisfactory capital position for is risk profile

Stronger supervisory action could have included an informal enforcement action to address the credit administration and internal control weaknesses contained in the December 2007 examination report and/or requiring the bank to hold additional capital consistent with its growing risk profile. The FDIC became sharply critical of the bank's lending practices and capital position during the February 2009 examination as management struggled to address projects that were experiencing difficulty. Examiners made numerous recommendations and issued a C&D to address the underwriting of renewals and extensions, and overall portfolio administration and monitoring. However, by that time, the institution's lending markets were deteriorating, making remedial efforts difficult. Earlier supervisory intervention may have better positioned the bank to work through the loan deterioration that developed as the Puerto Rico real estate market deteriorated, mitigating, to some extent, the financial problems experienced by the bank.

Supervisory Response to Non-Core Funding Reliance

The FDIC initially identified concerns with R-G Premier's liquidity risk management practices during the September 2005 examination. During the examination, the FDIC issued a C&D that required the bank to, among other things, develop a liquidity plan. Examiners reviewed the plan during the examination and determined that it was acceptable. Notwithstanding the continued uncertainties associated with the bank's improper accounting for mortgage loan transactions, examiners determined that the bank's liquidity risk management practices were generally satisfactory and assigned a component rating of "2" for Liquidity at the conclusion of the examination.

Examiners determined during the October 2006 examination that the bank's liquidity risk management practices continued to be generally satisfactory and assigned a component rating of "2" for Liquidity. Examiners also recommended that the bank improve its liquidity and funds management practices in a number of areas. Among other things, examiners recommended that the bank enhance its liquidity plan to identify and assess the adequacy of contingency funding sources, including circumstances in which the bank might use them. Examiners also recommended that the bank perform liquidity stress testing and document its liquidity risk limits.

Examiners expressed concern with respect to the bank's tightening liquidity position during the December 2007 examination but concluded that the bank's liquidity risk management practices were generally adequate and assigned a component rating of "2" for Liquidity. Notably, the December 2007 examination report recommended that the bank develop a contingency funding plan for brokered deposits that would address, among other things, potential statutory restrictions on this funding source should the bank's PCA capital category fall below *Well Capitalized*. During the February 2009 examination, examiners found that R-G Premier's liquidity risk profile had increased substantially and assigned a component rating of "4" for Liquidity. Among other things, examiners determined that the bank had far less balance sheet liquidity than it did during the prior examination and that brokered deposits had increased 16 percent during 2008 to $2.2 billion. However, the bank had not developed a contingency plan for its brokered deposits as examiners had recommended in the prior examination.

The OCFI transmitted the results of the February 2009 examination on August 3, 2009. The examination results stated that the bank was considered *Adequately Capitalized* for PCA purposes and, as a result, was prohibited from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. In a letter dated August 24, 2009, R-G Premier requested that the FDIC grant the institution a brokered deposit waiver. At that time, the bank had an average of $97 million in brokered deposits maturing monthly, and without continued access to brokered deposits, the bank would experience a liquidity crisis. The FDIC granted R-G Premier a limited brokered deposit waiver in a letter dated October 23, 2009. The waiver allowed the bank to renew its brokered deposits in an amount equal to 75 percent of the amount of brokered deposits recorded on the bank's balance sheet as of October 23, 2009. The waiver permitted the bank to renew these brokered deposits through January 31, 2010.

In a letter dated December 30, 2009, the institution requested that the FDIC extend the bank's brokered deposit waiver through April 30, 2010. During January 2010, when the FDIC was considering the brokered deposit waiver, the preliminary results of the November 2009 TAQR indicated substantial deterioration in the bank's loan portfolio. Based on the preliminary results of the review, it appeared that the bank would become *Significantly Undercapitalized*. DSC examination staff informed us that the results of the TAQR were analyzed closely in early 2010 because of significant differences between examiner and internal bank classifications at R-G Premier, Westernbank Puerto Rico, and Eurobank. Specifically, examiners for the three banks conducted a horizontal review in January 2010 to ensure that CRE loan classifications were consistent for the institutions. In a letter dated February 12, 2010, the FDIC approved R-G Premier's request for an extension of its brokered deposit waiver.

Part 325 of the FDIC Rules and Regulations states that 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 finalize the results of the TAQR until late April 2010. The review concluded that the bank was indeed *Significantly Undercapitalized*. On April 27, 2010, the FDIC hand-delivered a letter to R-G Premier's Board stating that the bank was considered S*ignificantly Undercapitalized* and that the institution could no longer accept, renew, or roll over brokered deposits. The OCFI closed R-G Premier 3 days later.

Supervisory Lessons Learned

While banks in Puerto Rico faced unique challenges in attracting core deposits, earlier supervisory concern with respect to the bank's heavy reliance on brokered deposits might have been prudent. Specifically, examiners could have expanded their recommendations to improve the bank's liquidity and funds management practices during the October 2006 examination to address the need for the bank to reduce is reliance on brokered deposits and develop a viable contingency plan in the event that brokered deposits became restricted. A viable contingency plan could have also considered funding risks and uncertainties caused by the bank's accounting issues. Examiners recommended that the bank develop a contingency plan for brokered deposits during the December 2007 examination. However, the bank did not address this recommendation. Heightened monitoring of the bank's use of brokered deposits following the October 2006 examination might have been beneficial. Earlier action to address the bank's heavy reliance on brokered deposits may have influenced R-G Premier's Board to reduce its reliance on brokered deposits, thereby reducing the bank's liquidity risk profile.

In August 2008, the FDIC issued FIL-84-2008, entitled *Liquidity Risk Management*, which stresses the importance of contingency funding plans for institutions the use wholesale funding sources, including brokered deposits. In addition, in March 2009, the FDIC issued FIL 13-2009, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions that are in Weakened Condition*. FIL 13-2009 states that FDIC-supervised institutions having a composite rating of "3," "4," or "5" are expected to establish and implement appropriate plans to mitigate the risks associated with the use of potentially volatile liabilities.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to 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 cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC 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. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to R-G Premier, the FDIC properly implemented applicable PCA provisions of section 38. Among other things, the FDIC formally notified the bank when its capital category changed; considered the bank's capital category when making safety and soundness decisions, including decisions on brokered deposit waivers, as discussed in the prior section of this report; reviewed and monitored the institution's Call Reports and liquidity reports; and conducted periodic discussions with the institution's management regarding its efforts to raise needed capital and comply with applicable PCA restrictions. Table 3 illustrates R-G Premier's capital levels relative to the PCA thresholds for *Well Capitalized* institutions as reported by the institution in its Call Reports.

Table 3: R-G Premier's Capital Levels, 2005 to 2009

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
Well Capitalized Thresholds	**5% or more**	**6% or more**	**10% or more**	
R-G Premier's Capital Levels				
Dec-2005	5.27	9.98	10.95	*Well Capitalized*
Dec-2006	5.83	10.37	11.54	*Well Capitalized*
Dec-2007	6.37	10.13	11.39	*Well Capitalized*
Dec-2008	5.84	8.50	9.78	*Adequately Capitalized*
Dec-2009	5.53	7.53	8.81	*Adequately Capitalized*

Source: UBPRs for R-G Premier.
Note: Many of the capital ratios in the table reflect the results of amended Call Reports filed by R-G Premier after an initial Call Report had been filed. The narrative below provides a chronological description of the changes in the bank's capital categories and the FDIC's implementation of PCA.

R-G Premier was considered *Well Capitalized* until August 3, 2009, when the OCFI formally transmitted the results of the February 2009 examination to the bank's Board indicating that the institution was *Adequately Capitalized*. Examiners noted during the examination that R-G Premier had overstated its capital position as of December 31, 2008 by approximately $98 million because the bank had not provided an adequate provision for loan loss. As a result, R-G Premier's initial Call Report filing for December 31, 2008 indicating that the bank was *Well Capitalized* was not correct.[16] The FDIC directed R-G Premier to amend its Call Reports to reflect the results of the February 2009 examination. The FDIC also reminded the institution of the restrictions imposed on *Adequately Capitalized* institutions, including the restriction on the solicitation, renewal, and roll over of brokered deposits without an approved waiver from the FDIC.

[16] R-G Premier's initial Call Report filing for December 31, 2008 reflected Tier 1 Leverage, Tier 1 Risk-Based, and Total Risk-Based Capital ratios of 6.88 percent, 9.89 percent, and 11.16 percent, respectively.

As an *Adequately Capitalized* institution, R-G Premier was not required to develop a capital restoration plan under PCA. However, examiners determined during the February 2009 examination that bank's capital position was deficient given its risk profile. As a result, the FDIC and the OCFI included a provision in the October 2009 amended C&D that required the bank to submit a capital restoration plan within 45 days of the Order. R-G Premier submitted such a plan to the FDIC on December 7, 2009. Generally, the plan focused on finding a merger partner, transferring assets between an affiliate, cost-cutting initiatives, asset sales, and asset quality improvement. The plan also indicated that another institution planned to conduct due diligence at the bank during the first quarter of 2010 and that discussions with other investors were underway.

On April 5, 2010, R-G Premier's Board Chairman notified the FDIC's Case Manager for R-G Premier that the institution referenced above had concluded its due diligence but was no longer interested in an open bank transaction. In addition, no other prospective investors had been identified. In a letter dated April 19, 2010, the FDIC notified R-G Premier's Board that the bank's capital restoration plan was unacceptable and that the Board needed to immediately provide the FDIC with its plans to contribute capital or sell or merge the bank with another federally insured depository institution. In a hand-delivered letter dated April 27, 2010, the FDIC notified the bank's Board that, based on further substantial deterioration in the bank's financial condition identified during the November 2009 TAQR, the bank was considered *Significantly Undercapitalized*. The OCFI closed the bank 3 days later because it did not have sufficient capital to support its operations and its liquidity position was severely strained.

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 DSC Director provided a written response to the draft report. That response is provided in its entirety as Appendix 5 of this report. In the response, DSC reiterated the OIG's conclusions regarding the causes of R-G Premier's failure. With regard to our assessment of the FDIC's supervision of R-G Premier, DSC reiterated the supervisory activities described in our report and noted that the bank's Board and management were unable to adequately address supervisory recommendations and enforcement measures.

The response noted that DSC has issued guidance to enhance its supervision of institutions, such as R-G Premier, that rely heavy on volatile funding sources. In addition, the response noted that DSC had completed an examiner training program that emphasized a forward-looking approach to assessing a bank's risk profile. The response added that the early use of informal enforcement actions to pursue correction 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 Deposit Insurance Fund 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) 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 R-G Premier's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of R-G Premier, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

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 R-G Premier's operations from 2004 until it failed on April 30, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution during the same period. To accomplish the objectives, we performed the following procedures and techniques:

- Analyzed examination reports and other supervisory documents prepared by the FDIC and the OCFI from 2004 until the bank closed.
- Reviewed the following:
    - Institution data in Call Reports, UBPRs, and other reports.
    - FDIC and OCFI correspondence, including correspondence maintained in DSC's New York Regional Office.
    - Relevant reports prepared by DRR and DSC relating to the institution's closure, including records maintained by DRR in Puerto Rico.

    - Pertinent FDIC regulations, policies, procedures, and guidance.

- Interviewed DSC personnel in the FDIC's New York, Jamesburg, NJ, and San Juan offices.

- Interviewed OCFI examiners and managers to obtain their perspectives and discuss their role in the supervision of the institution.

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, and interviews of examiners to understand R-G Premier's management controls pertaining to the causes of failure and material losses 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 was 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 was 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 the provisions of PCA. We performed limited tests to determine compliance with certain aspects of the FDI Act and the FDIC Rules and Regulations. The results of our tests are 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.

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 indicated that the OIG planned to provide more in-depth coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional

Objectives, Scope, and Methodology

material loss review 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 material loss reviews.

In addition, with respect to more in-depth 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 providing 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.
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.
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.
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 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

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.
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.
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.
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. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.

Glossary of Terms

Section 23A	Section 23A (1) establishes limits on the amount of ‘‘covered transactions’’ between a member bank and its affiliates (any one affiliate and in the aggregate as to all affiliates); (2) requires that all covered transactions between a member bank and its affiliates be on terms and conditions that are consistent with safe and sound banking practices; (3) prohibits the purchase of low quality assets from an affiliate; and (4) requires that extensions of credit by a member bank to an affiliate, and guarantees on behalf of affiliates, be secured by statutorily defined amounts of collateral.
Tier 1 (Core) Capital	In general, this term is 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).
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 data reported in Reports of Condition and Income submitted by banks.
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.

ACRONYMS

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
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
FDI	Federal Deposit Insurance
IO	Interest Only
MOU	Memorandum of Understanding
NYSE	New York Stock Exchange
OCFI	Office of the Commissioner of Financial Institutions
OIG	Office of Inspector General
PCA	Prompt Corrective Action
PRIC	Puerto Rico Investment Company
RGFC	R&G Financial Corporation
SEC	Securities and Exchange Commission
TAQR	Targeted Asset Quality Review
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Apparent Violations and Contraventions, 2004 to 2009

Applicable Laws, Rules and Regulations	Description	2009	2007	2006	2005	2004
FDIC Rules and Regulations Section 363.4(a) and (b)	Requires insured institutions to file with regulators copies of an annual report containing audited annual financial statements.	✓	✓	✓		
FDIC Rules and Regulations Section 323.3(a)(7)(i)	Requires appraisals for certain real estate-related transactions unless there has been no obvious and material change in market conditions.	✓				
FDIC Rules and Regulations Part 337.3(a)	Provides that all insured nonmember banks are subject to the restrictions contained in FRB regulations prohibiting a bank from paying an overdraft for executive officers and directors of banks and affiliates.				✓	
Federal Reserve Bank Regulations Section 23A	States in part that loans and other extensions of credit issued on behalf of an affiliate by a member bank or its subsidiary shall be secured at the time of the transaction by collateral having a market value of 120 percent of the amount of such loan or extension of credit.	✓	✓	✓	✓	✓
Federal Reserve Bank Regulations Section 23B	Provides in part that a member bank and its subsidiaries may engage in a covered transaction with an affiliate on terms and under circumstances, including credit standards, that are substantially the same as those involving nonaffiliated companies.	✓	✓		✓	
Investment Securities and End-User Derivatives Activities, August 31, 1998	States in part that institutions should have policies that specify the types of market risk analyses that should be conducted for various types or classes of instruments prior to their acquisition.				✓	
Joint Agency Policy Statement on Interest Rate Risk, July 12, 1996	States in part that each institution should conduct periodic reviews of the interest rate risk management process.	✓	✓		✓	
Interagency Statement of Policy on the Allowance for Loan and Lease Losses, December 29, 2006	States in part that the ALLL level should be prudent, conservative, but not excessive, and that the ALLL should fall within an acceptable range of estimated losses, which are appropriate for the risk inherent in the portfolio.	✓	✓			
Interagency Policy Statement on the Internal Audit Function and its Outsourcing	States that each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities.	✓				

Corporation Comments

FDIC

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 R-G Premier Bank of Puerto Rico, Hato Rey, Puerto Rico (Assignment No. 2010-068)

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 R-G Premier Bank of Puerto Rico, Hato Rey, Puerto Rico (R-G), 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 received on November 10, 2010.

R-G failed primarily because the Board and management did not provide effective oversight and failed to react in a timely manner to the deteriorating economic conditions in Puerto Rico. During the years preceding its failure, R-G increased its exposure to acquisition, development and construction loans without commensurate credit administration and related monitoring practices. The inadequate practices coupled with lax underwriting led to the development of loan problems when Puerto Rico's real estate market deteriorated. Provisions and loan losses associated with this deterioration depleted R-G's earnings, eroded its capital, and strained its liquidity, as it relied on brokered deposits to fund its operations. Ultimately, R-G did not have sufficient capital to support its operations and its liquidity position was severely strained.

The FDIC and OCFI conducted annual joint examinations, offsite monitoring activities and targeted asset quality reviews. In 2005, R-G's management component rating was lowered to a "3" based, in part, on less than satisfactory risk management practices. In 2007, the FDIC and OCFI downgraded R-G's composite rating to "3," and continued to progressively downgrade component and composite ratings at subsequent examinations and used enforcement actions to secure R-G's correction of deficiencies. R-G's Board and management was unable 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 R-G, 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.