Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-036

Material Loss Review of North Houston Bank, Houston, Texas, and Madisonville State Bank, Madisonville, Texas

May 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of the Inspector General (OIG) conducted a material loss review of the failures of North Houston Bank, Houston, Texas (North Houston) and Madisonville State Bank, Madisonville, Texas (Madisonville). On October 30, 2009, the Texas Department of Banking (TDB) closed the institutions and named the FDIC as receiver. On November 20, 2009, the FDIC notified the OIG that North Houston's total assets at closing were $325.3 million and the estimated loss to the Deposit Insurance Fund (DIF) was $38 million and that Madisonville's total assets at closing were $237.8 million and the estimated loss to the DIF was $33.1 million. As of January 29, 2010, the estimated loss for North Houston had increased to $47.1 million and the estimated loss for Madisonville had decreased to $27.6 million.

North Houston and Madisonville were wholly-owned subsidiaries of the FBOP Corporation, a privately-held financial holding company headquartered in Oak Park, Illinois. Because both institutions were under common ownership and followed a similar business model, we have addressed both failures in this report. FBOP controlled one other FDIC-supervised institution, the Community Bank of Lemont (Lemont), Lemont, Illinois, which was closed by the Illinois Department of Financial and Professional Regulation on October 30, 2009. We did not include Lemont in this review because the loss was not material as that term is defined in the FDI Act. The combined assets of North Houston and Madisonville represented approximately 3 percent of the total assets held by FBOP's nine subsidiary institutions as of October 30, 2009. Almost 95 percent of the total assets held by FBOP's subsidiary institutions pertained to four national banks. The U.S. Department of the Treasury OIG is conducting a separate material loss review of these four national banks.

The objectives of this audit were to (1) determine the causes of failure for North Houston and Madisonville and the resulting material losses to the DIF and (2) evaluate the FDIC's supervision of the institutions, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

Background

North Houston was established in 1963 as a state chartered nonmember institution. The institution was acquired by FBOP in 1995, and at the time of its closing, operated a single office in Houston, Texas. North Houston's loan portfolio consisted primarily of commercial real estate (CRE) loans, a large percentage of which pertained to acquisition, development, and construction (ADC). North Houston also maintained a securities portfolio consisting primarily of preferred shares in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)—two Government Sponsored Enterprises (GSE).

Madisonville was established in 1902 as the First National Bank of Madisonville. In 1980, the institution was purchased by the First City Bancorporation of Texas, Inc., and in 1993 it was acquired by FBOP. Madisonville operated a single office in the small community of Madisonville, Texas, which is located approximately 90 miles north of Houston. Because local loan demand was low, the majority of the institution's loan portfolio consisted of out-of-territory loan participations purchased through FBOP. These loan participations generally pertained to CRE. Madisonville also maintained a securities portfolio consisting primarily of preferred shares in Fannie Mae and Freddie Mac.

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Audit Results

Causes of Failures and Material Losses

North Houston and Madisonville failed primarily because their Boards and management did not effectively manage the risks associated with the institutions' investment securities, particularly Fannie Mae and Freddie Mac preferred stock. Between November and December 2007, North Houston and Madisonville purchased $46.5 million and $28 million, respectively, in the preferred shares of Fannie Mae and Freddie Mac. Although these securities were generally viewed as having low credit risk at the time they were purchased, the amounts acquired exceeded the institutions' capital as of December 31, 2007. In addition, neither institution had a viable exit strategy to mitigate losses in the event that market conditions for these securities became adverse. In July 2008, investor concern over the financial condition of Fannie Mae and Freddie Mac resulted in a significant decline in the market value of their preferred shares. The securities declined further during the following month, and on September 7, 2008, the GSEs were placed into conservatorship, eliminating much of the remaining market value of the preferred shares.

The losses incurred by North Houston and Madisonville on their investments in Fannie Mae and Freddie Mac materially impaired the institutions' capital positions. In an effort to recapitalize the institutions, FBOP made capital infusions into North Houston and Madisonville on September 30, 2008 totaling $22.4 million and $7.8 million, respectively. In addition, both institutions recognized significant amounts of deferred tax assets (DTA) as regulatory capital based on their losses in the Fannie Mae and Freddie Mac preferred shares. However, the FDIC subsequently determined that the capital infusions were ineligible for treatment as regulatory capital and that the amounts of DTAs included in the institutions' regulatory capital significantly exceeded regulatory limitations.

Adding to the financial difficulties at North Houston and Madisonville was a deterioration in the quality of the institutions' CRE loan portfolios. Both institutions, which had histories of high CRE loan concentrations, grew their CRE loan portfolios substantially in late 2007 and early 2008, just as the nation's credit and real estate markets were beginning to decline. This growth increased the institutions' exposure to a sustained downturn in the real estate market and reduced their ability to absorb losses due to unforeseen adverse events. Further, a lack of due diligence pertaining to loan purchases and weak credit administration and loan review practices contributed to the loan quality problems that developed when the real estate market declined. The losses associated with North Houston's and Madisonville's investment securities, together with a decline in their CRE loan portfolios, depleted the institutions' capital and strained their liquidity. TDB closed North Houston and Madisonville on October 30, 2009 because the institutions were unable to raise sufficient capital to support their operations.

The FDIC's Supervision of North Houston and Madisonville

The FDIC, in coordination with TDB, provided ongoing supervisory oversight of North Houston and Madisonville through regular onsite risk management examinations, visitations, and offsite monitoring activities. The FDIC also coordinated extensively with representatives of the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System (the Federal Reserve) on supervisory issues of mutual interest. Further, the FDIC had regular discussions with representatives of FBOP regarding issues affecting the holding company and its subsidiary institutions, such as FBOP's ongoing efforts to raise needed capital. Through these efforts, the FDIC identified risks in North

Houston's and Madisonville's operations and brought these risks to the attention of the institutions' Boards and management.

With respect to key risks and issues, the FDIC's supervisory oversight of the risks associated with North Houston's and Madisonville's investments in Fannie Mae and Freddie Mac preferred shares was generally reasonable. However, the failures of North Houston and Madisonville offer an important lesson learned with respect to investment securities that are not explicitly backed by the full faith and credit of the U.S. government. That is, when institutions make significant investments in such securities, the FDIC should ensure that sound risk management controls are in place and implemented. Such controls include prudent limits relative to total capital and viable exit strategies to mitigate losses when market conditions for the securities become adverse.

We also reviewed the FDIC's supervision of FBOP's efforts to recapitalize the institutions by infusing capital and including DTAs in regulatory capital. Regarding the capital infusions, the FDIC took appropriate steps to support its final determination that the infusions provided to North Houston and Madisonville on September 30, 2008 were ineligible for treatment as regulatory capital. However, the FDIC's final determination could have been made sooner. The FDIC expressed concern about the capital infusions to FBOP and the institutions' management on multiple occasions. However, state examination reports transmitted to the institutions while the capital infusions were under review did not raise concerns regarding the matter. An earlier final determination may have impacted the FDIC's supervisory strategy for the institutions and prompted more immediate corrective action by FBOP. With respect to the DTAs, the FDIC took appropriate steps to ensure that the amounts of DTAs included in the institutions' regulatory capital were consistent with the limitations defined in the FDIC Rules and Regulations. However, the FDIC's communications with FBOP regarding this matter were generally informal and not always documented.

Finally, examiners could have expanded their criticisms of North Houston's and Madisonville's CRE concentration risk management practices in the November 2006 and March 2007 examination reports. Expanded criticism in this regard may have influenced the institutions to curb their CRE loan growth in late 2007 and early 2008 and implement stronger controls before the real estate market began to decline.

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all insured depository 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 long-term cost to the DIF. Based on the supervisory actions taken with respect to North Houston and Madisonville, the FDIC properly implemented applicable PCA provisions of section 38.

Management Response

The Director, Division of Supervision and Consumer Protection (DSC), provided a written response to a draft of this report on May 19, 2010. In its response, DSC reiterated the OIG's conclusions regarding the causes of failure for North Houston and Madisonville. DSC also noted that it worked cooperatively with the OCC, the Federal Reserve, and the TDB in coordinating the supervision of FBOP and its subsidiary institutions.

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FDIC

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226

Office of Material Loss Reviews
Office of Inspector General

DATE: May 20, 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 North Houston Bank, Houston, Texas, and Madisonville State Bank, Madisonville, Texas* (Report No. MLR-10-036)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failures of North Houston Bank, Houston, Texas (North Houston) and Madisonville State Bank, Madisonville, Texas (Madisonville). The Texas Department of Banking (TDB) closed both institutions on October 30, 2009 and named the FDIC as receiver. North Houston and Madisonville were wholly-owned subsidiaries of the FBOP Corporation, a privately-held financial holding company headquartered in Oak Park, Illinois. Because both institutions were under common ownership and followed a similar business model, we have addressed both failures in this report. FBOP controlled one other FDIC-supervised institution, the Community Bank of Lemont (Lemont), Lemont, Illinois, which was closed by the Illinois Department of Financial and Professional Regulation (IDFPR) on October 30, 2009. We did not include Lemont in this review because the institution's loss is not material as that term is defined in the FDI Act.

The combined assets of North Houston and Madisonville represented approximately 3 percent of the total assets held by FBOP's nine subsidiary institutions as of October 30, 2009. Almost 95 percent of the total assets held by FBOP's subsidiary institutions pertained to four national banks.[2] The U.S. Department of the Treasury (Treasury) OIG is conducting a separate material loss review of these four national banks.

On November 20, 2009, the FDIC notified the OIG that North Houston's total assets at closing were $325.3 million and the estimated loss to the Deposit Insurance Fund (DIF) was $38 million and that Madisonville's total assets at closing were $237.8 million and the estimated loss to the DIF was $33.1 million. As of January 29, 2010, the estimated loss for North Houston had increased to $47.1 million and the estimated loss for Madisonville

[1] As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.
[2] The four banks are the California National Bank, San Diego National Bank, Pacific National Bank, and Park National Bank.

had decreased to $27.6 million. 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 audit objectives were to (1) determine the causes of failure for North Houston and Madisonville and the resulting material losses to the DIF and (2) evaluate the FDIC's supervision[3] of the institutions, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of the failures of North Houston and Madisonville and the FDIC's efforts to ensure that the Boards of Directors (Boards) and management operated the institutions in a safe and sound manner.

The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss reviews, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[4] Appendix 1 contains a timeline of key events pertaining to capital infused into the institutions in September 2008; Appendix 2 contains details on our objectives, scope, and methodology; Appendix 3 contains a glossary of terms; Appendix 4 contains a list of acronyms; and Appendix 5 contains the Corporation's comments.

Background

Incorporated in 1982, FBOP had a total of nine FDIC-insured subsidiary institutions operating in Illinois, California, Texas, and Arizona. The FDIC served as the primary federal regulator for three of the nine institutions and the Office of the Comptroller of the Currency (OCC) served as the primary federal regulator for the remaining six institutions. All nine institutions were considered affiliates for purposes of Section 23A of the Federal Reserve Act, made applicable to insured nonmember institutions by Section 18(j) of the FDI Act.[5] FBOP also had numerous non-bank subsidiaries, including real estate development and holding companies, financial services firms, and capital trusts. Table 1

[3] 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 insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.
[4] For example, in May 2010, the FDIC OIG's Office of Evaluations initiated a review of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, PCA and section 39, Safety and Soundness Standards) in the banking crisis.
[5] See the glossary for more information regarding Section 23A's definition of affiliates.

summarizes the total assets, estimated losses, and primary federal regulators for FBOP's subsidiary institutions at the time of their closures on October 30, 2009.

Table 1: Total Assets, Losses, and Regulators for FBOP's Subsidiary Institutions

Institution Name and Location	Total Assets at Closing	Estimated Loss to the DIF	Primary Federal Regulator
California National Bank, Los Angeles, CA	$6,989,399,069	$972,222,695	OCC
San Diego National Bank, San Diego, CA	$3,560,021,170	$365,251,237	OCC
Pacific National Bank, San Francisco, CA	$2,086,184,690	$225,005,987	OCC
Park National Bank, Chicago, IL	$4,701,034,638	$655,615,430	OCC
North Houston Bank, Houston, TX	$325,253,289	$47,131,825	FDIC
Madisonville State Bank, Madisonville, TX	$237,781,212	$27,603,906	FDIC
Bank USA, NA, Phoenix, AZ	$193,991,795	$21,315,867	OCC
Citizens National Bank, Teague, TX	$120,708,029	$24,930,664	OCC
Community Bank of Lemont, Lemont, IL	$84,963,982	$24,129,505	FDIC
Totals	**$18,299,337,874**	**$2,363,207,116**	

Source: Failed institution information provided by the FDIC's Division of Finance as of January 29, 2010.

FBOP was an interrelated enterprise and, as such, key business strategies were generally determined on a corporate-wide basis. For example, FBOP significantly influenced the management of its subsidiary institutions' capital, liquidity, and investment strategies; facilitated the purchase and sale of loans among its subsidiary institutions; and provided various operational services to its subsidiary institutions, such as internal audit, financial accounting and reporting, and information technology support. FBOP was wholly-owned by its Chairman and Chief Executive Officer (CEO), who also served as Board Chairman of North Houston and Madisonville. As such, this individual exercised significant control over the strategic and business decisions pertaining to both institutions.

North Houston

North Houston was established in 1963 as a state-chartered nonmember institution. The institution was acquired by FBOP in 1995 and, at the time of the institution's closing, operated a single office in Houston, Texas. North Houston's loan portfolio consisted primarily of commercial real estate (CRE) loans, a large percentage of which pertained to acquisition, development, and construction (ADC). The institution originated large loans in the Houston market and participated the loans to FBOP affiliates, including Madisonville. In addition, North Houston purchased participations in large CRE loans originated by other FBOP affiliates. North Houston also maintained a securities portfolio consisting primarily of preferred shares in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).[6]

[6] Fannie Mae and Freddie Mac are Government Sponsored Enterprises (GSE). See the glossary for more information and Fannie Mae and Freddie Mac.

The FDIC and TDB considered the management team at North Houston to be experienced and capable, as reflected in the supervisory component ratings[7] of "1" or "2" assigned to management at every examination between 2004 and 2006. Table 2 summarizes selected financial information pertaining to North Houston for the 9-month period ended September 30, 2009 and for the 4 preceding calendar years.

Table 2: Selected Financial Information for North Houston

Financial Measure ($000s)	Sept - 09	Dec - 08	Dec - 07	Dec - 06	Dec - 05
Total Assets	311,140	351,092	382,814	301,025	382,688
Gross Loans and Leases	265,518	290,177	292,143	269,058	317,592
Investment Securities	19,457	19,068	67,352	18,381	46,214
Deposits	307,166	251,276	275,228	238,777	226,510
Net Income (Loss)	-24,777	-29,853	4,322	5,221	7,022

Source: Uniform Bank Performance Reports (UBPR) for North Houston.

Madisonville

Madisonville was established in 1902 as the First National Bank of Madisonville. In 1980, the institution was purchased by the First City Bancorporation of Texas, Inc., and in 1993 it was acquired by FBOP. Madisonville operated a single office in the small community of Madisonville, Texas, which is located approximately 90 miles north of Houston. Because local loan demand was low, the majority of the institution's loan portfolio consisted of out-of-territory loan participations purchased through FBOP's Purchased Asset Program.[8] These loan participations generally pertained to CRE and were often collateralized by retail shopping centers and multi-family residential properties. Madisonville also maintained a securities portfolio consisting primarily of preferred shares in Fannie Mae and Freddie Mac. Like North Houston, the FDIC and TDB considered Madisonville's management team to be strong, as reflected in the supervisory component ratings of "1" assigned to management at every examination between 2004 and 2007. Table 3 summarizes selected financial information pertaining to Madisonville for the 9-month period ended September 30, 2009 and for the 4 preceding calendar years.

[7] Pursuant to the Uniform Financial Institutions Rating System (UFIRS), federal and state regulators assign supervisory ratings to financial institutions based on the results of safety and soundness examinations and other supervisory activities. Ratings consist of a "composite" rating reflecting the institution's overall financial condition and operations and six "component" ratings 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. Ratings are assigned on a scale of 1 to 5, with 1 representing the least supervisory concern and 5 representing the greatest supervisory concern.

[8] FBOP used its Purchased Asset Program to purchase loan pools, packaged loans, and other credits for placement in subsidiary institutions.

Table 3: Selected Financial Information for Madisonville

Financial Measure ($000s)	Sept - 09	Dec - 08	Dec - 07	Dec - 06	Dec - 05
Total Assets	244,027	244,411	212,923	177,754	190,720
Gross Loans and Leases	188,369	208,395	159,288	132,409	154,693
Investment Securities	11,094	12,587	42,384	8,939	29,465
Deposits	224,653	189,830	154,690	150,152	144,923
Net Income (Loss)	-5,152	-13,195	2,675	3,798	4,064

Source: UBPRs for Madisonville.

Causes of Failures and Material Losses

North Houston and Madisonville failed primarily because their Boards and management did not effectively manage the risks associated with the institutions' investment securities, particularly Fannie Mae and Freddie Mac preferred stock. Between November and December 2007, North Houston and Madisonville purchased $46.5 million and $28 million, respectively, in the preferred shares of Fannie Mae and Freddie Mac. Although these securities were generally viewed as having low credit risk at the time they were purchased, the amounts acquired exceeded the institutions' capital as of December 31, 2007. In addition, neither institution had a viable exit strategy to mitigate losses in the event that market conditions for these securities became adverse. In July 2008, investor concern over the financial condition of Fannie Mae and Freddie Mac resulted in a significant decline in the market value of their preferred shares. The securities declined further during the following month, and on September 7, 2008, the Director of the Federal Housing Finance Agency (FHFA)[9] placed Fannie Mae and Freddie Mac into conservatorship, eliminating much of the remaining market value of the preferred shares.

The losses incurred by North Houston and Madisonville on their investments in Fannie Mae and Freddie Mac materially impaired the institutions' capital positions. In an effort to recapitalize the institutions, FBOP made capital infusions into North Houston and Madisonville on September 30, 2008 totaling $22.4 million and $7.8 million, respectively. In addition, both institutions recognized significant amounts of deferred tax assets (DTA)[10] as regulatory capital based on their losses in the Fannie Mae and Freddie Mac preferred shares. However, the FDIC subsequently determined that the capital infusions were ineligible for treatment as regulatory capital and that the amounts of DTAs included in the institutions' regulatory capital significantly exceeded regulatory limitations.

Adding to the financial difficulties at North Houston and Madisonville was a deterioration in the quality of the institutions' CRE loan portfolios. Both institutions, which had histories of high CRE loan concentrations, grew their CRE loan portfolios substantially in

[9] *The Housing and Economic Recovery Act of 2008* created the FHFA and provided it with the authority to place Fannie Mae or Freddie Mac into conservatorship or receivership, if necessary, to restore them to a sound financial condition.

[10] A DTA is the potential tax benefit of operating losses. It represents the amount by which taxes receivable are expected to be realized from Net Operating Loss carrybacks or future operating income. The amount of DTAs that may be included in Tier 1 Capital is limited by regulation. See the glossary for more information.

late 2007 and early 2008, just as the nation's credit and real estate markets were beginning to decline. This growth increased the institutions' exposure to a sustained downturn in the real estate market and reduced their ability to absorb losses due to unforeseen adverse events. Further, a lack of due diligence pertaining to loan purchases and weak credit administration and loan review practices contributed to the loan quality problems that developed when the real estate market declined. The losses associated with North Houston's and Madisonville's investment securities, together with a decline in their CRE loan portfolios, depleted the institutions' capital and strained their liquidity. TDB closed North Houston and Madisonville on October 30, 2009 because the institutions were unable to raise sufficient capital to support their operations.

Although not a cause of failure for North Houston or Madisonville, the FDIC's Board of Directors determined that assessing a cross-guarantee liability against Park National Bank and Citizens National Bank in connection with the failure of FBOP's other seven subsidiary institutions would result in the least cost to the DIF. Under the FDI Act, an insured depository institution is liable for any loss that the FDIC incurs, or reasonably expects to incur, in connection with resolving a commonly-controlled institution. This is generally referred to as "cross-guarantee liability." At the time of their closure, Park National Bank and Citizens National Bank were experiencing a deterioration in the quality of their assets. However, the OCC determined that statutory grounds did not yet exist to support the appointment of a receiver for either institution. After assessing Park National Bank and Citizens National Bank for the anticipated losses of the other seven failed subsidiary institutions, both institutions immediately became insolvent and the OCC appointed the FDIC as receiver.[11]

Investment Securities

The overall investment strategy for institutions in the FBOP organization was determined at the holding company level, with specific investment decisions approved by each institution's Board. Notably, the Chairman and CEO of FBOP also served as the Board Chairman for seven of the holding company's nine subsidiary institutions, including North Houston and Madisonville. As described below, North Houston and Madisonville incurred significant losses in connection with their investments in the preferred shares of Fannie Mae and Freddie Mac and corporate bonds issued by other financial institutions. These losses were the principal causes of failure for both institutions.

Fannie Mae and Freddie Mac Preferred Shares

Between November and December 2007, North Houston and Madisonville purchased $46.5 million and $28 million, respectively, of the preferred shares of Fannie Mae and Freddie Mac. These investments, which were made at the direction of the holding company's management, were part of a corporate-wide strategy to deploy almost $900 million in liquid resources in relatively low-risk investment securities. The Chairman and

[11] As previously mentioned, the Treasury OIG is conducting a material loss review covering Park National Bank. A material loss review of Citizens National Bank is not required because the institution's loss is not material as that term is defined in the FDI Act.

CEO of FBOP determined that these investments represented an acceptable risk at the time they were made because the securities carried a favorable credit risk rating of "AA" and there was a public perception that the GSEs were implicitly backed by the federal government. In addition, there were no specific regulatory limits on the amounts of Fannie Mae and Freddie Mac preferred shares that North Houston and Madisonville could purchase and the securities paid an attractive dividend yield.

Although the preferred shares of Fannie Mae and Freddie Mac were generally viewed as having low credit risk at the time of their purchase, the amounts acquired by the institutions exceeded their capital as of December 31, 2007. Section 3.3, *Securities and Derivatives*, of the *DSC Risk Management Manual of Examination Policies* states that concentrations in specific issuers, market sectors, and instrument types should be limited. In addition, Fannie Mae and Freddie Mac's preferred shares were not explicitly backed by the full faith and credit of the U.S. government, and the FDIC's general risk-based capital rules for state chartered, nonmember institutions required a 100-percent risk weighting for both GSEs' preferred shares.[12] Further, both Fannie Mae and Freddie Mac were experiencing financial difficulties when the securities were purchased, and neither North Houston nor Madisonville had viable exit strategies in the event that market conditions for the securities became adverse.

In July 2008, investor concern over the financial condition of Fannie Mae and Freddie Mac resulted in a sharp decline in the market value of the GSEs' preferred shares. Immediately following this decline, the Treasury, the Board of Governors of the Federal Reserve System (the Federal Reserve), and the Congress implemented a number of actions intended to support both GSEs.[13] Although these actions resulted in a brief price recovery for the preferred shares, the securities declined further in August, and on September 7, 2008, the Director of FHFA placed Fannie Mae and Freddie Mac into conservatorship. As a result of the conservatorships, the preferred shares lost almost all of their value, requiring FBOP's subsidiary institutions to recognize a combined impairment loss of approximately $838 million in September 2008. Of this amount, North Houston and Madisonville took write-downs totaling $42.9 million and $25.5 million, respectively. The figure on the following page illustrates the performance of Fannie Mae's and Freddie Mac's preferred shares between November 30, 2007 and September 8, 2008 (the first day of trading after the GSEs were placed into conservatorship).

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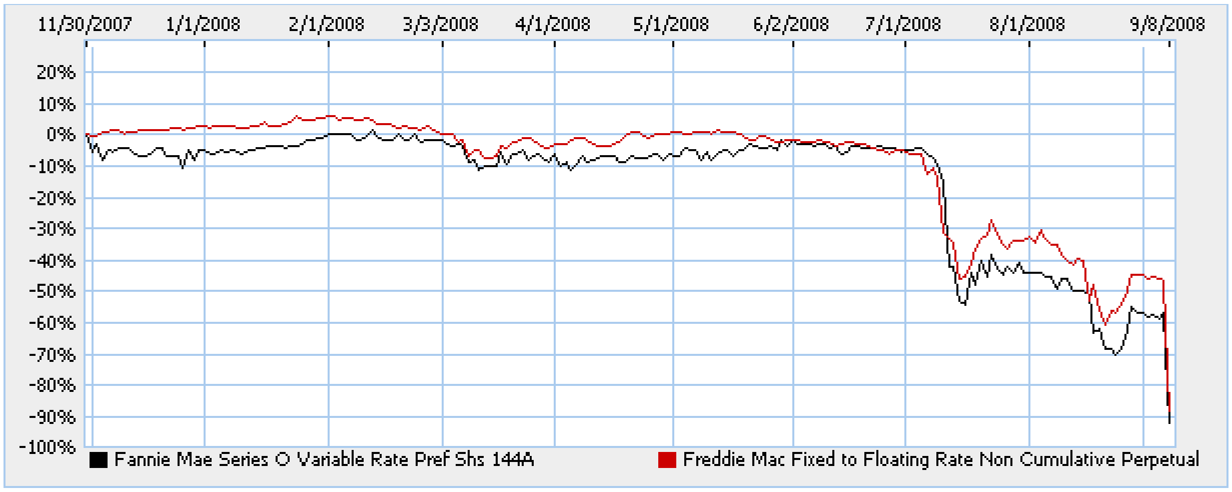
[12] The FDIC's general risk-based capital rules require institutions to assign their assets to 1 of 5 risk weight categories—0 percent, 20 percent, 50 percent, 100 percent, and 200 percent. See the *Risk-based Capital Rules* in the glossary for further information.

[13] Such actions included, among other things, allowing Fannie Mae and Freddie Mac to borrow funds from the Federal Reserve and the enactment of the *Housing and Economic Recovery Act of 2008*. The Act provided the Treasury with increased lending authority for the GSEs and emergency authority (expiring on December 31, 2009) to purchase an unlimited amount of GSE debt or equity securities, if necessary.

Performance of Fannie Mae and Freddie Mac Preferred Shares



Source: Publicly available information on the performance of Fannie Mae's Series O preferred shares and Freddie Mac's Series Z preferred shares.

<u>Corporate Bonds</u>

In addition to Fannie Mae and Freddie Mac preferred shares, North Houston and Madisonville held corporate bonds issued by financial institutions with exposure to the housing market. Although these securities were generally rated investment grade at the time they were purchased, some fell below investment grade and lost significant value in 2008 and 2009. For example, North Houston and Madisonville took write-downs totaling $5.3 million and $3 million, respectively, on their corporate bond holdings during 2008. The institutions experienced further deterioration in their corporate bond holdings during 2009 as additional bonds fell below investment grade and lost significant value.

<u>Impact of Securities Losses on Regulatory Capital</u>

The losses incurred by North Houston and Madisonville in connection with their investments in Fannie Mae and Freddie Mac materially impaired the institutions' capital positions. Maintaining *Well Capitalized* positions for PCA purposes was critical to the viability of both institutions because they depended heavily on wholesale funding sources, particularly brokered deposits and Federal Home Loan Bank (FHLB) borrowings, to fund their loans and maintain liquidity. Such funding sources can become limited or restricted when an institution falls below a *Well Capitalized* position. Notably, North Houston's and Madisonville's net non-core funding dependence ratios[14] as of September 30, 2008 were 65 percent and 57 percent, respectively. Such ratios placed the institutions at the top of their peer groups for net non-core funding dependence. North Houston's liquidity risk

[14] The net non-core funding dependence ratio is a measure of the degree to which an institution relies on non-core funding to support longer-term assets (e.g., loans that mature in more than 1 year). An elevated ratio reflects heavy reliance on potentially volatile funding sources that may not be available in times of financial stress. For purposes of this report, the terms non-core funding and wholesale funding have substantially the same meaning.

profile was particularly high. Without ready access to wholesale funding sources, the institution would have likely experienced a near-term liquidity crisis.

In an effort to return the institutions to *Well Capitalized* positions, FBOP provided capital infusions to North Houston and Madisonville. In addition, both institutions included significant amounts of DTAs in their Tier 1 Capital. However, as described below, the FDIC subsequently determined that the capital infusions were ineligible for treatment as regulatory capital. In addition, the DTA amounts included in the institutions' Tier 1 Capital significantly exceeded regulatory limitations. A description of the capital infusions and DTAs, along with their impact on the institutions' regulatory capital, follows.

- **Capital Infusions.** On September 30, 2008, four FBOP subsidiary institutions made $40 million in loans to two non-bank subsidiaries. On the same day, the non-bank subsidiaries paid the $40 million as cash dividends to FBOP, which immediately infused the funds into five subsidiary institutions as capital. North Houston and Madisonville received $22.4 million and $7.8 million, respectively, of the $40 million in capital infusions from FBOP.

- **Deferred Tax Assets.** As of September 30, 2008, North Houston and Madisonville booked approximately $16 million and $9 million, respectively, in DTAs in connection with the institutions' losses on Fannie Mae and Freddie Mac preferred shares.

In separate letters dated November 21, 2008, the FDIC notified the Boards of North Houston and Madisonville that the capital infusions received on September 30, 2008 were being reviewed to determine whether they should be recognized as regulatory capital. The letters also notified the institutions that their September 30, 2008 Consolidated Reports of Condition and Income (Call Report) appeared to include excessive amounts of DTA as regulatory capital. With regard to the DTAs, the letters referenced Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations which generally provides that the maximum allowable amount of DTAs that are dependent upon future taxable income, net of any valuation allowance, is limited to the lesser of (1) the amount of DTA dependent upon future taxable income expected to be realized within 1 year based on projected future taxable income for that year or (2) 10 percent of Tier 1 Capital before deducting certain disallowed assets. The DTA amounts recognized by North Houston and Madisonville for regulatory capital purposes represented 56 percent and 59 percent, respectively, of their Tier 1 Capital. Both figures were well in excess of the 10 percent limitation defined in Part 325.

At the direction of the FDIC, the institutions amended their September 30, 2008 Call Reports to reduce the amounts of DTA included in their Tier 1 Capital consistent with the limitations defined in Part 325. As a result of these reductions, the institutions fell to *Undercapitalized* positions. As discussed later in this report, FBOP requested, but did not obtain, regulatory relief from the FDIC with respect to the 10-percent limitation defined in Part 325. On December 31, 2008, FBOP infused additional capital into North Houston and Madisonville totaling $6 million and $5.5 million, respectively. FBOP also purchased loans from North Houston totaling almost $61 million on December 31, 2008, which had the effect of improving the institution's regulatory capital ratios. As a result of these transactions, the institutions reported *Well Capitalized* positions in their December 31, 2008 Call Reports.

In September 2009, the FDIC notified North Houston and Madisonville that the capital infusions received on September 30, 2008 could not be recognized as regulatory capital. In making its determination, the FDIC noted that three of the four subsidiary institutions (including North Houston) that had made loans to the non-bank subsidiaries to facilitate the capital infusions received capital totaling $10 million in return. Based on Emerging Issues Task Force Issue No. 85-1, *Classifying Notes Received for Capital Stock*, the FDIC concluded that these institutions received what was in substance a note, rather than an asset. Accordingly, the institutions should have reported the note receivable from the non-bank subsidiaries as a reduction of equity capital in their Call Reports. The FDIC noted that this accounting treatment reflected the lack of economic substance to a transaction in which a purported increase in equity capital is in the form of an unpaid note receivable from the contributor of the capital. This accounted for $10 million of the $40 million in cash infusions.

The FDIC determined that the remaining $30 million in capital infusions failed to provide capital support to the institutions collectively and their ability to absorb losses. Because of the cross-guarantee liability under Section 5(e) of the FDI Act, the FDIC determined that it was both appropriate and necessary to consider the cash infusions in the context of FBOP and its subsidiaries on a combined basis for regulatory accounting purposes. Although individual institutions received cash from FBOP, the source of the cash was the loans from other FBOP institutions. When viewed in this manner, the FDIC determined that the combined institutions essentially received notes, rather than cash, as contributions to their equity capital. Accordingly, the FDIC directed the institutions to amend their Call Reports for the reporting periods at issue to exclude from regulatory capital the amounts pertaining to the infusions. After making these adjustments, North Houston and Madisonville reported *Critically Undercapitalized* and *Significantly Undercaptialzed* positions, respectively, in their September 30, 2009 Call Reports.

CRE Loan Concentrations

As of December 31, 2007, approximately 95 percent of North Houston's $292.1 million loan portfolio and 86 percent of Madisonville's $159.3 million loan portfolio consisted of CRE loans. As of that same date, North Houston had an additional $259 million in unfunded loan commitments, of which $257 million (or 99 percent) pertained to CRE. Madisonville's unfunded loan commitments as of December 31, 2007 totaled $18.3 million, of which $16.6 million (or 91 percent) pertained to CRE. Table 4 reflects the institutions' CRE loan concentrations relative to total capital as compared to their peer groups. These high CRE concentrations made both institutions vulnerable to a sustained downturn in the real estate market.

Table 4: North Houston's and Madisonville's CRE Concentrations Compared to Peer Groups

Year Ended	North Houston's CRE Relative to Total Capital	Peer Group Average and Percentile Ranking	Madisonville's CRE Relative to Total Capital	Peer Group Average and Percentile Ranking
Dec – 08	865%	380% (98 percentile)	824%	164% (99 percentile)
Dec – 07	598%	377% (88 percentile)	511%	169% (97 percentile)
Dec – 06	466%	371% (69 percentile)	397%	169% (92 percentile)
Dec – 05	555%	358% (85 percentile)	444%	158% (96 percentile)

Source: UBPRs for North Houston and Madisonville.

In December 2006, the FDIC, OCC, and Federal Reserve issued joint guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. Although the guidance does not establish specific CRE lending limits, it does define criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk. According to the 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.

As of December 31, 2007, North Houston's and Madisonville's non-owner occupied CRE loans represented 582 percent and 489 percent, respectively, of the institutions' total capital. These levels were significantly higher than the levels defined in the 2006 guidance as possibly warranting further supervisory analysis. Although North Houston and Madisonville had a history of high CRE loan concentrations, neither institution had adequate concentration risk management controls. Among other things, neither institution had established a comprehensive, written CRE lending policy that included prudent concentration limits and contingency plans for reducing or mitigating concentrations under adverse market conditions. Further, between September 30, 2007 and March 31, 2008, North Houston and Madisonville grew their loan portfolios by $82.3 million (or 31 percent) and $64.7 million (or 46 percent), respectively. Almost all of this increase consisted of CRE and ADC loans purchased from affiliates or through FBOP's Purchased Asset Program. This CRE growth strategy was implemented just as the nation's credit and real estate markets were beginning to deteriorate, reducing the institutions' ability to absorb losses due to unforeseen adverse events.

In July 2009, the FDIC and TDB initiated examinations of North Houston and Madisonville. Although both institutions were closed before final examination reports were issued, examiners identified a significant deterioration in each institution's loan portfolio. With respect to North Houston, examiners noted that $61.6 million of the institution's $264.2 million loan portfolio (or 23 percent) should be classified. These classifications consisted principally of CRE and ADC loans in Texas. In its final Call Report for the quarter ended September 30, 2009, North Houston reported that almost 13 percent of its loan portfolio was in nonaccrual status. With respect to Madisonville, examiners noted that $24.9 million of the institution's $190.1 million loan portfolio (or 13 percent) should be classified. These classifications consisted principally of out-of-territory CRE loan participations. Madisonville reported in its September 30, 2009 Call Report that almost 7 percent of the institution's loan portfolio was in nonaccrual status.

Due Diligence, Credit Administration, and Loan Review

Madisonville did not perform adequate due diligence when it acquired CRE loans though FBOP's Purchased Asset Program. In addition, both institutions exhibited various credit administration weaknesses and Madisonville's loan review function was not adequate. Although not primary causes of failure, the lack of adequate due diligence, credit administration, and loan reviews were contributing factors in the CRE loan quality problems that developed when the institutions' lending markets declined. A brief description of these weaknesses follows.

Due Diligence

The DSC *Risk Management Manual of Examination Policies* states that institutions purchasing loan participations must make a thorough, independent evaluation of the transactions and the risks involved before committing any funds. Institutions should also apply the same standards of prudence, credit assessment, approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan. At the time of the December 2008 examination, 86 percent of Madisonville's loan portfolio consisted of loans acquired through the Purchased Asset Program. Generally, the institution relied on due diligence performed by FBOP and the entities that originated the loans, rather than performing its own independent assessment of the loans prior to purchase. Examiners noted during the March 2007, December 2008, and July 2009 examinations that management often lacked detailed knowledge or information for the loans it purchased and had to contact the lead institution to obtain answers to examiner questions. Examiners noted that management's lack of familiarity with its loans limited the institution's ability to take necessary action before deterioration resulted in adverse classifications.

Credit Administration and Loan Review

Examiners identified various credit administration and loan review weaknesses in the years leading to the institutions' failures. Such weaknesses included, but were not limited to:

- Loan documentation exceptions for a large percentage of loans reviewed by examiners. Exceptions principally consisted of stale financial information on borrowers.

- Failure to document the validity of key assumptions used in real estate appraisals. In some cases, appraisals were not updated when appropriate. The lack of sufficient information in some appraisals resulted in apparent violations of Part 323, *Appraisals*, of the FDIC Rules and Regulations.

- A weak internal loan review function at Madisonville.

The FDIC's Supervision of North Houston and Madisonville

The FDIC, in coordination with TDB, provided ongoing supervisory oversight of North Houston and Madisonville through regular onsite risk management examinations, visitations, and offsite monitoring activities. The FDIC also coordinated extensively with representatives of the OCC and the Federal Reserve on supervisory issues of mutual interest. Further, the FDIC had regular discussions with representatives of FBOP regarding issues affecting the holding company and its subsidiary institutions, such as FBOP's ongoing efforts to raise needed capital. Through these efforts, the FDIC identified risks in North Houston's and Madisonville's operations and brought these risks to the attention of the institutions' Boards and management.

With respect to key risks and issues, the FDIC's supervisory oversight of the risks associated with North Houston's and Madisonville's investments in Fannie Mae and Freddie Mac preferred shares was generally reasonable. However, the failures of North Houston and Madisonville offer an important lesson learned with respect to investment securities that are not explicitly backed by the full faith and credit of the U.S. government. That is, when institutions make significant investments in such securities, the FDIC should ensure that sound risk management controls are in place and implemented. Such controls include prudent limits relative to total capital and viable exit strategies to mitigate losses when market conditions for the securities become adverse.

We also reviewed the FDIC's supervision of FBOP's efforts to recapitalize the institutions by infusing capital and including DTAs in regulatory capital. Regarding the capital infusions, the FDIC took appropriate steps to support its final determination that the infusions provided to North Houston and Madisonville on September 30, 2008 were ineligible for treatment as regulatory capital. However, the FDIC's final determination could have been made sooner. The FDIC expressed concern about the capital infusions to FBOP and the institutions' management on multiple occasions. However, state examination reports transmitted to the institutions while the capital infusions were under review did not raise concerns regarding the matter. An earlier final determination may have impacted the FDIC's supervisory strategy for the institutions and prompted more immediate corrective action by FBOP. With respect to the DTAs, the FDIC took appropriate steps to ensure that the amounts of DTAs included in the institutions' regulatory capital were consistent with the limitations defined in the FDIC Rules and Regulations. However, the FDIC's communications with FBOP regarding this matter were generally informal and not always documented.

Finally, examiners could have expanded their criticisms of North Houston's and Madisonville's CRE concentration risk management practices in the November 2006 and March 2007 examination reports. Expanded criticism in this regard may have influenced the institutions to curb their CRE loan growth in late 2007 and early 2008 and implement stronger controls before the real estate market began to decline.

Supervisory History

The FDIC and TDB conducted five onsite risk management examinations and two visitations of North Houston between October 2004 and the institution's failure. In addition, the FDIC and TDB conducted five onsite examinations and one visitation of Madisonville between March 2004 and the institution's failure. Table 5 summarizes key supervisory information pertaining to these examinations and visitations.

Table 5: Onsite Examinations and Visitations of North Houston and Madisonville

Institution Name	Examination Start Date	Type of Examination	Regulator	Supervisory Ratings	Informal or Formal Actions Taken*
North Houston	10/25/2004	Risk Management	FDIC	111122/1	None
	12/05/2005	Risk Management	TDB	112112/1	None
	11/13/2006	Risk Management	FDIC	111121/1	None
	07/21/2008	Risk Management	TDB	433243/3	MOU
	12/09/2008	Visitation	FDIC	-	-
	04/13/2009	Visitation	FDIC/TDB	-	None
	07/27/2009	Risk Management	FDIC/TDB	555555/5**	C&D Issued
Madisonville	03/29/2004	Risk Management	FDIC	121121/1	None
	08/29/2005	Risk Management	TDB	111122/1	None
	03/29/2007	Risk Management	FDIC	111121/1	None
	12/29/2008	Risk Management	TDB	333333/3	MOU
	12/26/2008	Visitation	FDIC	-	-
	07/27/2009	Risk Management	FDIC/TDB	555555/5**	C&D Issued

Source: OIG analysis of examination reports and information in the FDIC's Virtual Supervisory Information on the Net system (ViSION) for North Houston and Madisonville.
* Informal enforcement actions often take the form of Bank Board Resolutions or Memoranda of Understanding (MOU). Formal enforcement actions often take the form of Cease and Desist (C&D) orders, but under severe circumstances can also take the form of insurance termination proceedings.
** Final examination reports were not issued for these examinations. However, the FDIC processed interim ratings downgrades in September 2009 based on the preliminary results of the examinations.

The FDIC's offsite monitoring procedures generally consisted of contacting the institutions' management from time to time to discuss current and emerging business issues and using automated tools[15] to help identify potential supervisory concerns. The

[15] 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.

FDIC's offsite monitoring did not identify serious problems at the institutions prior to the decline in the preferred shares of Fannie Mae and Freddie Mac. The December 2008 visitation of North Houston focused on liquidity and a $4 million loan to a non-bank subsidiary of FBOP that was part of the September 2008 capital infusions. The April 2009 visitation of North Houston focused on asset quality. The December 2008 visitation of Madisonville, which was conducted in conjunction with the December 2008 state examination, focused primarily on capital and liquidity, but also included coverage of the institution's asset quality.

Based on the results of North Houston's July 2008 examination (which was transmitted to the institution on January 9, 2009) and Madisonville's December 2008 examination (which was transmitted to the institution on May 1, 2009), the TDB downgraded each institution's composite rating to a "3." In addition, the FDIC and TDB also determined that MOUs were warranted to clearly define the regulatory expectations for restoring the institutions to a safe and sound condition and to define certain management goals and corrective actions. North Houston's and Madisonville's MOUs became effective on May 8, 2009 and June 19, 2009, respectively. Among other things, the MOUs required that the institutions:

- Submit a written capital plan to achieve and maintain Tier 1 leverage capital and total risk-based capital ratios of 8 percent and 12 percent, respectively.
- Develop and follow a plan to reduce the institutions' dependence on non-core funding sources.
- Adopt a risk management program for identifying, measuring, monitoring, and controlling CRE concentrations commensurate with the risk profile of the institutions and the December 2006 interagency guidance, entitled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*.

Based on the preliminary results of the July 2009 examinations of the institutions, examiners determined that the actions taken by North Houston and Madisonville to address the provisions of the MOUs were not adequate. Examiners also determined that the financial condition of the institutions had deteriorated significantly following the prior examinations. On September 16, 2009, the FDIC and TDB notified North Houston and Madisonville that the institutions' composite ratings were being downgraded to a "5" and that the viability of the institutions was in serious jeopardy. The notification also advised the institutions that the FDIC had determined, on a preliminary basis, that the capital infusions received from FBOP on September 30, 2008 were ineligible for treatment as regulatory capital. On October 7, 2009, the FDIC and TDB implemented C&Ds for both institutions that required, among other things, Tier 1 Capital and total risk-based capital ratios of at least 9 percent and 12 percent, respectively; contingency funding plans; and plans to reduce credit concentrations. TDB closed both institutions on October 30, 2009 because the institutions were not operating with sufficient capital to support their operations.

Oversight of Fannie Mae and Freddie Mac Investments

Like many insured institutions, North Houston and Madisonville invested in the preferred shares of Fannie Mae and Freddie Mac because the securities were generally viewed as having low credit risk at the time the investments were made. The institutions purchased the preferred shares in November and December 2007, between onsite examinations of the institutions. In addition, the FDIC's offsite monitoring tools did not flag the investments as a concern. According to information in the FDIC's ViSION system, an FDIC examiner contacted Madisonville's President and CEO on February 11, 2008 to discuss current and prospective issues that could impact the institution. During the discussion, the President and CEO advised the examiner that the institution had recently purchased preferred shares of Fannie Mae and Freddie Mac. The examiner recommended that the President and CEO closely monitor the value of the securities for potential other-than-temporary-impairment (OTTI) charges. However, no serious concerns regarding the securities were raised. ViSION did not contain information regarding discussions between the FDIC and North Houston during late 2007 and early 2008.

As previously discussed, the Treasury, Federal Reserve, and Congress announced a number of initiatives in July 2008 in response to concerns over the financial condition of Fannie Mae and Freddie Mac. Although these initiatives resulted in a brief price recovery for the preferred shares of the GSEs, the shares resumed their decline in August 2008. At that time, the FDIC recognized that institutions holding preferred shares in Fannie Mae and Freddie Mac could be required to recognize OTTI charges, causing some institutions to fall below *Well Capitalized* for PCA purposes. To address this risk, the Chicago Regional Office, working in coordination with the Washington Office, began a region-wide analysis in August 2008 to identify insured institutions with exposure to Fannie Mae and Freddie Mac preferred shares. As part of this effort, regional office personnel worked with representatives of North Houston and Madisonville to assess the impact that the securities were having on the institutions' capital. On September 7, 2008, Fannie Mae and Freddie Mac were placed in conservatorship, resulting in North Houston and Madisonville recognizing significant OTTI charges as of September 30, 2008. The FDIC immediately began to work with FBOP to assess its plans for recapitalizing its subsidiary institutions, including North Houston and Madisonville.

The FDIC's supervisory oversight of the risks associated with North Houston's and Madisonville's investments in Fannie Mae and Freddie Mac preferred shares was generally reasonable. However, the failures of North Houston and Madisonville offer an important lesson learned with respect to investment securities that are not explicitly backed by the full faith and credit of the U.S. government. That is, when institutions make significant investments in such securities, the FDIC should ensure that institutions establish and implement sound risk management controls, such as prudent investment limits relative to capital and exit strategies. In the case of North Houston and Madisonville, the amounts of Fannie Mae and Freddie Mac preferred shares acquired exceeded the institutions' capital as of December 31, 2007. In addition, the institutions had not established viable exit strategies in the event that market conditions for the securities became adverse.

Assessment of Capital Infusions

As discussed earlier, FBOP provided capital infusions to North Houston and Madisonville on September 30, 2008 totaling $22.4 million and $7.8 million, respectively. While the FDIC took appropriate steps to support its final determination that the capital infusions were ineligible for treatment as regulatory capital, the FDIC's final determination could have been made sooner. In addition, despite the significance of the infusions to the capital positions of both institutions, state examination reports transmitted to the institutions in January 2009 and May 2009 did not note that the infusions were under review by the FDIC. See Appendix 1 for a detailed timeline of events pertaining to the capital infusions.

Timeliness of the FDIC's Final Determination on the Capital Infusions

On November 21, 2008, the Chicago Regional Office formally notified the Boards of North Houston and Madisonville that the FDIC was reviewing the capital infusions received on September 30, 2008 to determine whether they should be accorded treatment as regulatory capital. The notification was based on the concern that several of the FBOP subsidiary institutions that had made loans to facilitate the capital infusions also received capital in return. On November 25, 2008, the FDIC's Case Manager for North Houston and Madisonville notified FBOP's Chief Financial Officer (CFO) that the FDIC's Chief Accountant (Chief Accountant) had made a preliminary determination that the capital infusions should not qualify as regulatory capital. However, the Case Manager advised the CFO that the matter was still being reviewed by the FDIC and that a final determination had not yet been made. The Case Manager advised us that the Boards of North Houston and Madisonville were also reminded during meetings held on March 19, 2009 that the FDIC was continuing its review of the capital infusions. Finally, the President and CEO of North Houston acknowledged that the regulators were continuing to review the institution's $22.4 million capital infusion during a July 16, 2009 meeting with an FDIC examiner.

During the 6 months that followed the FDIC's November 2008 preliminary determination, limited progress was made by the FDIC in reaching a final determination on the capital infusions due to other high priority concerns with FBOP and the general deterioration in the banking sector. On May 14, 2009, the Chicago Regional Office sent a memorandum to the Chief Accountant describing the nature of the capital infusions and the reasons why the infusions should be disallowed for regulatory capital purposes. The memorandum noted that the Chief Accountant had already indicated during the fall of 2008 that the infusions would not qualify as regulatory capital and requested formal concurrence on the matter. On July 13, 2009, the Chicago Regional Office again requested the Chief Accountant's written concurrence on the May 14, 2009 memorandum. On July 15, 2009, the Chief Accountant provided the Chicago Regional Office with a formal opinion concluding that the capital infusions should not be recognized as regulatory capital.

In the weeks that followed, the FDIC consulted with representatives of the OCC, Federal Reserve, TDB, and IDFPR to reach consensus on the treatment of the capital infusions. After reaching consensus, the regulators met with representatives of FBOP on August 19, 2009 to discuss the preliminary determination that the capital infusions did not qualify as regulatory capital. The FBOP representatives disagreed with the preliminary determination and indicated that they believed the matter had already passed regulatory scrutiny as there had been no discussion of it since November 2008. However, the FDIC representatives indicated that it was made clear to the institutions that the capital infusions were an open item. The FDIC separately briefed the Boards of North Houston and Madisonville on the preliminary determination on September 8, 2009. During these meetings, the Boards disagreed with the preliminary determination and requested a meeting with DSC officials in the Washington Office.

On September 17, 2009, FBOP officials met with DSC officials in the Washington Office to discuss their disagreement regarding the preliminary determination. FBOP officials indicated during the meeting that they would immediately attempt to refinance the loans related to the capital infusions with outside lenders so that the funds could be recognized as regulatory capital. The FBOP representatives also requested that the FDIC delay making a final determination on the capital infusions because an unfavorable determination could negatively impact ongoing efforts to raise needed capital.

On September 24, 2009, a DSC official formally notified FBOP that $10 million of the $40 million in capital infusions had been incorrectly recognized as regulatory capital by FBOP's subsidiary institutions[16] and that FBOP should amend its Call Reports as appropriate. The notification also indicated that the FDIC and the OCC continued to be concerned about the substance of the remaining $30 million in capital infusions and that a determination regarding its eligibility for regulatory capital purposes would not be deferred. Unlike the $10 million portion of the capital infusions, a decision to disallow the $30 million portion was a safety and soundness determination delegated only to the DSC Director.[17] On September 25, 2009, the DSC Director formally notified the Boards of North Houston and Madisonville of a final determination that the $30 million was not eligible for treatment as regulatory capital and directed the institutions to amend their Call Reports accordingly. Although FBOP attempted to refinance the loans related to the capital infusions with an independent lender in order to recognize the funds as regulatory capital, these efforts were not completed before the institutions were closed on October 30, 2009.

FBOP and its subsidiary institutions could have been more proactive in addressing the FDIC's concerns pertaining to the capital infusions, particularly in light of the preliminary determination that was communicated to FBOP in November 2008 and subsequent reminders that the infusions remained under review. However, the FDIC's final determination on this matter, particularly with respect to the $10 million portion of the capital infusions, could have been made sooner. An earlier final determination may have

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[16] See the discussion under the *Impact of Securities Losses on Regulatory Capital* in the *Causes of Failures and Material Losses* section of this report for a description of the FDIC's final determination with respect to the $10 million and $30 million portions of the capital infusions.

[17] Section 325.5(b) of the FDIC Rules and Regulations states that the DSC Director may, if the Director finds that a particular Tier 1 or Tier 2 Capital component or balance sheet entry or account has characteristics or terms that diminish its contribution to an insured depository institution's ability to absorb losses, require the deduction of all or a portion of such component, entry, or account from Tier 1 or Tier 2 Capital.

affected the FDIC's supervisory strategy for the institutions, as disallowing the infusions for regulatory capital purposes would have rendered North Houston insolvent and Madisonville *Significantly Undercapitalized*. Such capital positions would have triggered restrictions on wholesale funding sources, possible formal enforcement actions, and in the case of North Houston, the potential closure of the institution. An earlier final determination also may have prompted more immediate corrective action by FBOP to address the matter.

<u>Treatment of Capital Infusions in State Examination Reports</u>

As previously discussed, the FDIC formally notified North Houston and Madisonville in November 2008 that the capital infusions were under review. The FDIC's Case Manager also notified FBOP's CFO in November 2008 that a preliminary determination had been made that the capital infusions were ineligible for regulatory capital purposes. In addition, the Case Manager informed us that the institutions' Boards were orally advised in March 2009 that the capital infusions continued to be reviewed by the FDIC. Further, the President and CEO of North Houston acknowledged in a July 16, 2009 meeting that the institution's $22.4 million capital infusion continued to be reviewed by regulators. Although the state examination reports transmitted to North Houston and Madisonville on January 9, 2009 and May 1, 2009, respectively, referenced the September 2008 capital infusions, the reports did not raise concern regarding the infusions or mention that the infusions were under review by the FDIC. Given the criticality of the capital infusions to the institutions' viability, it would have been prudent for the TDB to have included such concerns in the examination reports. Such action would have provided another avenue for instilling urgency in the institutions' Boards to pursue corrective measures.

Deferred Tax Assets

As previously discussed, the FDIC formally notified the institutions in a November 21, 2008 letter that their September 30, 2008 Call Reports appeared to include excessive amounts of DTA as regulatory capital. The DTA amounts recognized by North Houston and Madisonville represented 56 percent and 59 percent, respectively, of their Tier 1 Capital, exceeding the 10-percent limitation defined in the FDIC Rules and Regulations. On November 24, 2008, FBOP sent a letter to the Chicago Regional Office on behalf of the institutions requesting regulatory relief with respect to the 10-percent limitation. The request noted that the OCC had already approved a similar request for FBOP's national bank subsidiaries[18] and referenced a Joint Release issued on September 7, 2008 in which federal banking regulators indicated an intent to work with institutions adversely affected by GSE stock investments. Notwithstanding this request, North Houston and Madisonville modified their Call Reports in December 2008 to comply with the 10-percent limitation.

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[18] In a November 5, 2008 letter, the OCC notified FBOP that its subsidiary national banks must deduct from Tier 1 Capital only the amount of DTAs that exceed what the banks could reasonably expect to realize within 4 years of the quarter end Call Report, based on estimates of future taxable income for that year. The OCC's relief was effective until June 30, 2009, or the receipt of funds under the Capital Purchase Program (CPP).

DSC officials in the Chicago Regional Office and Washington Office informed us that the nature of FBOP's request was highly unusual and that only the FDIC's Board of Directors could have approved such a request. In addition, the FDIC Case Manager advised us that FBOP was orally informed shortly after the request was received that it was not likely that the request would be approved. On December 22, 2008, a Madisonville official inquired about the status of the request. DSC's Houston Field Office Supervisor advised several Madisonville officials and FBOP's CFO that the request would need to be presented to the FDIC's Board of Directors and that the Board would not likely consider the matter prior to February 2009. DSC management officials in the Chicago Regional Office and Washington Office advised us that, following internal deliberations, they did not support FBOP's request and a formal FDIC Board case was not prepared. As previously discussed, FBOP infused additional capital into North Houston and Madisonville on December 31, 2008, which helped both institutions return to *Well Capitalized* positions by the end of 2008.

The Case Manager advised us that there were periodic oral communications with FBOP regarding the status of its request. Further, the Case Manager stated that during the April 2009 timeframe, FBOP was informed that it was highly unlikely that the request would be approved by the FDIC, thereby affording FBOP an opportunity to withdraw its request. FBOP formally withdrew its request on April 29, 2009.

DSC took appropriate steps to ensure that the amounts of DTAs included in North Houston's and Madisonville's regulatory capital were consistent with the limitations defined in the FDIC Rules and Regulations. However, the FDIC's communications with FBOP regarding this matter were generally informal and not always documented. In this regard, the Chicago Regional Office recently issued a policy that formalized a prior expectation that correspondence from institutions be acknowledged in writing.

Supervisory Response to CRE Loan Concentrations

At the time of North Houston's November 2006 examination and Madisonville's March 2007 examination, real estate market conditions were generally favorable. In addition, North Houston's adversely classified assets were a manageable $9 million (or 19 percent of Tier 1 Capital and the Allowance for Loan and Lease Losses (ALLL)) and Madisonville's adversely classified assets were only $2.7 million (or 9 percent of Tier 1 Capital and the ALLL). Further, both institutions were *Well Capitalized* and FBOP had the financial capability of infusing capital and liquidity into the institutions on an as needed basis. Based on these factors, examiners determined that the overall financial and operational condition of the institutions was strong and assigned composite ratings and component ratings for asset quality of "1."

Although the financial condition of the institutions at the time of the 2006 and 2007 examinations was satisfactory, North Houston and Madisonville had concentrations in CRE representing 615 percent and 456 percent of total capital, respectively. In addition, both institutions lacked adequate concentration risk management controls and relied on wholesale funding sources to fund their loans.[19] Additionally, in the case of Madisonville, the institution had plans to significantly grow its loan portfolio during 2007. Examiners identified North Houston's and Madisonville's significant CRE loan concentrations in the November 2006 and March 2007 examination reports. In addition, examiners made recommendations to the institutions to improve their concentration monitoring practices. Examiners determined that the risks associated with the CRE concentrations were somewhat mitigated by geographic diversification within the institutions' loan portfolios.

During North Houston's July 2008 examination and Madisonville's December 2008 examination, examiners were sharply critical of both institutions' concentration risk management practices. Among other things, examiners recommended that the institutions adopt CRE limits and strategies for reducing CRE concentrations during adverse market conditions. Examiners also recommended that the institutions develop comprehensive written CRE policies that comply with the December 2006 guidance entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. By the time of the 2008 examinations, however, North Houston's and Madisonville's CRE concentrations had grown to 848 percent and 824 percent of total capital, respectively. These increases resulted primarily from significant CRE loan growth that occurred in late 2007 and early 2008.

In retrospect, examiners could have expanded their criticisms of North Houston's and Madisonville's CRE concentrations and weak concentration risk management controls during the 2006 and 2007 examinations. Specifically, examiners could have downgraded the institutions' component ratings for asset quality and/or expanded their recommendations to include the control improvements described in the 2008 examination reports. Expanded criticism in this regard may have influenced the institutions to curb their CRE loan growth in late 2007 and early 2008 and implement stronger controls before the real estate market began to decline.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all insured depository institutions. The section requires that regulators take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC 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.

[19] At the time of North Houston's November 2006 examination, the institution relied heavily upon wholesale funding sources to fund its CRE loans and maintain liquidity. At the time of Madisonville's March 2007 examination, the institution relied moderately on wholesale funding sources, but planned to increase its use of wholesale funding sources later in 2007 to support planned loan growth.

Based on the supervisory actions taken with respect to North Houston and Madisonville, the FDIC properly implemented applicable PCA provisions of section 38. Table 6 illustrates North Houston's and Madisonville's capital levels relative to the PCA thresholds for *Well Capitalized* institutions for the quarter ended September 30, 2009, and for the 4 preceding calendar years.

Table 6: North Houston's and Madisonville's Capital Levels

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	
North Houston's Capital Levels				
Dec – 05	12.03	12.96	14.13	*Well Capitalized*
Dec – 06	15.10	15.59	16.84	*Well Capitalized*
Dec – 07	11.78	11.04	12.52	*Well Capitalized*
Dec – 08	6.85	8.79	10.04	*Well Capitalized*
Sept – 09	2.23	2.69	2.69	*Critically Undercapitalized*
Madisonville's Capital Levels				
Dec – 05	14.08	16.37	17.62	*Well Capitalized*
Dec – 06	14.81	18.64	19.90	*Well Capitalized*
Dec – 07	12.37	13.52	15.21	*Well Capitalized*
Dec – 08	7.80	9.56	10.81	*Well Capitalized*
Sept – 09	2.92	4.11	5.72	*Significantly Undercapitalized*

Source: UBPRs for North Houston and Madisonville.

North Houston and Madisonville were considered *Well Capitalized* until September 2008, when both institutions incurred significant losses on investments in Fannie Mae and Freddie Mac. After receiving capital infusions from FBOP on September 30, 2008 and recognizing large amounts of DTAs in connection with their securities losses, the institutions reported *Well Capitalized* positions in their initial September 30, 2008 Call Reports. In November 2008, both institutions amended their September 30, 2008 Call Reports at the direction of the FDIC to reduce the amount of DTAs included in their Tier 1 Capital. After making these adjustments, North Houston and Madisonville notified the FDIC that their capital positions as of September 30, 2008 were actually *Undercapitalized*. After receiving additional capital infusions from FBOP on December 31, 2008, both institutions returned to *Well Capitalized* positions at year-end 2008.

Although North Houston and Madisonville reported *Well Capitalized* positions in their December 31, 2008 Call Reports, the FDIC and TDB determined that the institutions' capital levels were not commensurate with their risk profiles. As previously discussed, capital provisions were included in each institution's MOU requiring that the institutions maintain capital ratios above the minimum levels for *Well Capitalized* institutions. In the months that followed, neither institution was able to raise sufficient capital for their risk profiles. In addition, examiners noted instances during the July 2009 examination in which North Houston fell to *Adequately Capitalized* between Call Report filings, but did not notify the FDIC as required by Part 325. Examiners noted that North Houston continued to acquire brokered deposits during these periods in which the institution was *Adequately Capitalized*. As previously discussed, the FDIC issued C&Ds for both institutions in October 2009 that also included capital requirements.

FBOP began exploring options to raise capital at its subsidiary institutions immediately following its investment losses in Fannie Mae and Freddie Mac in September 2008. These efforts continued until FBOP's subsidiary institutions closed on October 30, 2009. Among other things, FBOP explored obtaining equity and debt investments from various financial institutions, individual investors, and private equity firms; selling subsidiary institutions and/or their branches; consolidating banking operations into a single financial institution; and applying for funds under the CPP described below. However, none of these efforts were successful.

Capital Purchase Program

On October 3, 2008, the President signed the Emergency Economic Stabilization Act of 2008 into law. Among other things, the Act authorized the Troubled Asset Relief Program (TARP), which is administered by the Treasury. Under TARP, the Treasury has implemented the CPP through which the Treasury purchases senior preferred stock (and, if appropriate, warrants of common stock) from viable institutions of all sizes. The Treasury issued guidelines for publicly-held financial institutions to apply for funds under the CPP on October 20, 2008. Guidelines for privately-held institutions, such as FBOP's institution subsidiaries, were issued on November 17, 2008. The CPP application period for publicly-held and privately-held institutions closed on November 14, 2008 and December 8, 2008, respectively.

Qualifying financial institutions[20] were permitted to apply for funds under the CPP after consulting with their primary federal regulator. After receiving an application for CPP funds, primary federal regulators used a standardized process established by the Treasury for evaluating the application. The evaluation process contained viability criteria (e.g., CAMELS ratings, capital levels, selected asset performance ratios, Community Reinvestment Act ratings) for use in assessing the applications. Applications that did not satisfy the viability criteria were forwarded to an interagency CPP Council comprised of senior officials from the FDIC, the OCC, the Federal Reserve, and the Office of Thrift Supervision. Based on its review, the CPP Council could have (1) recommended approval of an application to the TARP Investment Committee,[21] (2) requested more information from the applicant, or (3) recommended withdrawal of the CPP application.[22]

[20] Qualifying financial institutions refer to private and public U.S.-controlled banks, savings associations, bank holding companies, and certain savings and loan holding companies (engaged exclusively in financial activities) that are deemed healthy and viable.
[21] The TARP Investment Committee is comprised of a group of senior Treasury officials. This committee may grant preliminary approval of CPP applications, in which case the application is forwarded to the Assistant Secretary for Financial Stability within the Treasury. The Assistant Secretary has final authority to approve CPP applications.
[22] According to the *Initial Report to the Congress by the Office of the Special Inspector General for the Troubled Asset Relief Program*, dated February 6, 2009.

Because the FDIC was not the primary federal regulator of either FBOP or its largest subsidiary institution, the FDIC was not directly involved in processing FBOP's CPP application.[23] FBOP submitted an initial application for CPP funds in October 2008. However, the application was deferred as the Treasury had not yet issued CPP guidelines for privately-held institutions. After the Treasury issued guidelines for privately-held institutions, FBOP consulted with the Federal Reserve and the OCC and submitted an amended application for CPP funds on December 2, 2008. The amended application requested an investment of $544 million in senior preferred stock at the holding company level. As a condition of obtaining the CPP funds, FBOP committed to raising an additional $100 million in capital for its subsidiary institutions. After consideration of the application, and in recognition of the significant impact that the GSE write-downs had on FBOP's subsidiary institutions, the OCC supported the application.

On December 17, 2008, the CPP Council reviewed FBOP's application for CPP funds. On January 14, 2009, the CPP Council reviewed a slightly modified version of FBOP's application in which FBOP committed to raising additional capital. On both occasions, the CPP Council raised concerns about the content of the application, requested additional information, and deferred making a recommendation. In the months that followed, the FDIC and the OCC communicated regularly with FBOP regarding its efforts to raise needed capital. FBOP's inability to secure a definitive agreement for private capital, together with a deterioration in the financial condition of its subsidiary institutions, made the possibility of securing CPP funds less likely as time passed. FBOP was ultimately not approved for CPP funding.

Corporation Comments

We issued a draft of this report on May 5, 2010. DSC management subsequently provided us with additional information for our consideration. We made certain changes to our report based on this information, as appropriate. On May 19, 2010, the Director, DSC, provided a written response to the draft report. The response is presented in its entirety as Appendix 5 of the report. In its response, DSC reiterated the OIG's conclusions regarding the causes of failure for North Houston and Madisonville. DSC also noted that it had worked cooperatively with the OCC, the Federal Reserve, and the TDB in coordinating the supervision of FBOP and its subsidiary institutions.

[23] FBOP's primary federal regulator was the Federal Reserve. FBOP's largest subsidiary institution was the California National Bank. The primary federal regulator of the California National Bank was the OCC.

Appendix 1

Timeline of Key Events Related to the September 2008 Capital Infusions

Date	Management Event
September 30, 2008	North Houston and Madisonville notify the FDIC that the institutions have received capital infusions from FBOP totaling $22.4 million and $7.8 million, respectively.
November 12, 2008	The Case Manager requests that the regional accountant in the Chicago Regional Office (Chicago Regional Accountant) review the transactions surrounding the capital infusions to determine whether the infusions should be recognized as regulatory capital.
November 21, 2008	The Chicago Regional Director formally notifies the Boards of North Houston and Madisonville that the capital infusions are being reviewed by the FDIC to determine whether they should be accorded treatment for regulatory capital purposes.
November 25, 2008	The Chicago Regional Accountant advises the Case Manager that the FDIC's Chief Accountant has reviewed information pertaining to the capital infusions and discussed the matter with senior DSC executives in the Washington Office. Based on this analysis, it was the Chief Accountant's preliminary opinion that the infusions should not be recognized as regulatory capital.
November 25, 2008	In response to an inquiry from FBOP's CFO regarding the FDIC's review of the capital infusions, the Case Manager advises the CFO that the FDIC's Chief Accountant has made a preliminary determination that the capital infusions should not be treated as regulatory capital. However, the Case Manager adds that the matter continues to be reviewed and that a final decision has not yet been made.
November 26, 2008	The Case Manager requests that the CFO provide a written explanation describing why the capital infusions should be recognized as regulatory capital. The Case Manager advises the CFO that the explanation will be considered by the FDIC before a final determination is made. According to the Case Manager, a brief written explanation was provided by the CFO. However, DSC was unable to locate a copy of the explanation for our review.
December 9, 2008	The Chicago Regional Accountant notifies the Chief Accountant that the Chicago Regional Office is preparing a formal case to the DSC Director to disallow, for regulatory capital purposes, the capital infusions. The notification includes a detailed written analysis describing why the capital infusions should be disallowed as regulatory capital and requests the Chief Accountant's concurrence with the analysis. According to staff in the Chicago Regional Office, the Chief Accountant did not respond to this request.
December 9, 2008	The FDIC conducts a visitation of North Houston targeting capital and liquidity. The visitation includes a review of a $4 million loan made by North Houston to a non-bank subsidiary in connection with the capital infusion.

Timeline of Key Events Related to the September 2008 Capital Infusions

Date	Management Event
December 23, 2008	In response to an inquiry from the Houston Field Office Supervisor regarding the status of a final determination on the capital infusion, the Case Manager states that a memorandum to the Washington Office is being drafted.
February 3, 2009	The Case Manager advises DSC officials in the Chicago Regional Office and Washington Office that she needs to prepare a memorandum for the DSC Director for purposes of disallowing the capital infusions.
March 19, 2009	According to the Case Manager, the Boards of North Houston and Madisonville are orally notified that the capital infusions continue to be reviewed by the FDIC.
May 14, 2009	The Chicago Regional Office sends the Chief Accountant a memorandum describing the nature of the capital infusions and the rationale for disallowing the infusions for regulatory capital purposes. The memorandum notes that the Chief Accountant already provided a preliminary opinion on the matter in November 2008 and requests the Chief Accountant's formal concurrence.
June 29, 2009	The Case Manager notifies Chicago Regional Office management that a higher priority needs to be placed on resolving the capital infusions matter because examinations of North Houston and Madisonville are scheduled to begin the following month.
July 13, 2009	The Chicago Regional Accountant again notifies the Chief Accountant that the region's management is requesting written concurrence on the May 14, 2009 memorandum.
July 15, 2009	The Chief Accountant provides the Chicago Regional Office with a formal opinion that the capital infusions should not be recognized as regulatory capital.
July 16, 2009	The Chicago Regional Office provides a copy of the Chief Accountant's formal opinion to OCC representatives for their review and concurrence.
July 31, 2009	OCC officials advise the Chicago Regional Office that the OCC agrees with the Chief Accountant's formal opinion that the capital infusions should not qualify as regulatory capital.

Timeline of Key Events Related to the September 2008 Capital Infusions

Date	Management Event
August 13, 2009	FDIC officials hold a conference call with representatives of the OCC and the Federal Reserve to discuss the capital infusions. The participants agree that the issue needs to be discussed with FBOP and its subsidiary institutions as soon as possible.
August 19, 2009	Representatives of the FDIC, OCC, and Federal Reserve meet with representatives of FBOP to inform them of a preliminary determination that the capital infusions do not qualify as regulatory capital. The regulators note that a final determination will be made by the DSC Director and that the final determination could come at any time. The regulators provide FBOP representatives with an analysis indicating that if the capital infusions are disallowed, North Houston will become insolvent and Madisonville will fall to a *Significantly Undercapitalized* position. Given the high liquidity risk profiles for both institutions, the regulators request a corrective action plan. The FBOP representatives indicate that they believed this matter had already been resolved as there had been no communication regarding the issue since November 2008. The FDIC representatives indicated that it was made clear to the institutions that the matter was an open item. FBOP representatives disagree with the preliminary determination.
August 27, 2009	The Chicago Regional Director and Chief Accountant submit a formal request to the DSC Director to disallow the capital infusions for regulatory capital purposes.
September 8, 2009	The FDIC meets with the Boards of North Houston and Madisonville to discuss, among other things, the impact of a decision to disallow the capital infusions. The FDIC officials indicate that the DSC Director's decision on this matter could come at any time. During the meetings, both Boards disagree with the FDIC's preliminary determination.
September 17, 2009	Representatives of FBOP, including its Chairman and CEO, meet with DSC officials in the Washington Office to explain why the capital infusions should qualify as regulatory capital. However, the DSC officials are not persuaded to change their preliminary determination. During the meeting, FBOP officials indicate that they will immediately attempt to refinance the loans related to the capital infusions with outside lenders so that the funds could be recognized as regulatory capital. The FBOP representatives indicate that the loans could be refinanced within 30 days. The FBOP representatives also request that the FDIC delay making a final determination on the capital infusions because an unfavorable determination on this matter could negatively impact ongoing efforts to raise needed capital.

Timeline of Key Events Related to the September 2008 Capital Infusions

Date	Management Event
September 24, 2009	The FDIC formally notifies FBOP that $10 million of the $40 million in capital infusions was erroneously recognized as regulatory capital in the Call Reports of FBOP's subsidiary institutions. The notification directs FBOP to have its subsidiary institutions amend all affected Call Reports to correct the deficiencies. The notification also states that if FBOP can refinance the loans pertaining to the remaining $30 million in capital infusions using lenders independent of FBOP, the proceeds can be recognized as regulatory capital, but only from the date of refinancing going forward. Prior Call Reports would still need to be modified if the DSC Director determines that the infusions are ineligible for regulatory capital. Finally, the notification advises FBOP that the FDIC will not defer a determination on the capital infusions and that prospective equity investors in FBOP should be advised that the capital infusions are being reviewed by the FDIC to determine their eligibility for regulatory capital purposes.
September 25, 2009	The DSC Director formally notifies North Houston and Madisonville that the capital infusions are not eligible for treatment as regulatory capital and directs the institutions to amend their Call Reports accordingly.
October 23, 2009	The President and CEO of Madisonville contacts the Chicago Regional Office to advise that the loans subject to the ineligible capital determinations are in the process of being refinanced and this effort should be completed by the end of October 2009. However, the refinancing efforts are not completed before the subsidiary institutions are closed.
October 30, 2009	North Houston and Madisonville are closed.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides, in general, that if a 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 FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

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

We conducted this performance audit from February through May 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 North Houston's and Madisonville's operations from December 2005 until their failures on October 30, 2009. Our review also entailed an evaluation of the regulatory supervision of the institutions over the same period.

To achieve the objectives, we performed the following audit procedures:

- Analyzed key documentation, including:
  - Examination and visitation reports issued by the FDIC and TDB between 2005 and 2009.
  - Institution data in Call Reports, UBPRs, and other relevant reports.
  - FDIC and TDB correspondence.
  - Reviewed formal and informal actions taken by the FDIC and TDB.
  - Pertinent FDIC regulations, policies, procedures, and guidance.
- Interviewed DSC examination staff in the Washington Office, the Chicago Regional Office, and the Houston Field Office.

Objectives, Scope, and Methodology

- Interviewed TDB examination staff to obtain their perspectives on the failures and to discuss their role in the supervision of the institutions.

- Spoke with OCC officials to obtain their perspective on certain supervisory matters.

- Coordinated our work the Treasury OIG's material loss review of the national bank subsidiaries in the FBOP organization.

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, examination reports, and interviews of examiners to understand North Houston's and Madisonville's management controls pertaining to causes of failures 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 were used to support our audit conclusions.

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

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

Glossary of Terms

Term	Definition
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.
Affiliate	Under section 23A of the Federal Reserve Act (12 U.S.C. section 371c), an affiliate generally includes, among other things, a bank subsidiary, or a company that (1) controls the bank and any other company that is controlled by the company that controls the bank, (2) is sponsored and advised on a contractual basis by the bank, or (3) is controlled by or for the benefit of shareholders who control the bank or in which a majority of directors hold similar positions in the bank.
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.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council’s (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC’s Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
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.
Credit Rating	An indicator of the credit risk of one or more securities assigned by a nationally recognized statistical rating organization, such as Moody’s Investors Service, Standard & Poor’s Corporation, or Fitch Investors Service. In general, a credit rating of AA indicates that the underlying obligator has a very strong capacity to meet its financial commitments, but not as strong as the highest rating of AAA.

Glossary of Terms

Term	Definition
Deferred Tax Asset (DTA)	DTAs are assets that reflect, for reporting purposes, amounts that will be realized as reductions of future taxes or as future receivables from a taxing authority. DTAs may arise because of specific limitations requiring that certain net operating losses or tax credits be carried forward if they cannot be used to recover taxes previously paid. These "tax carryforwards" are realized only if the institution generates sufficient future taxable income during the carryforward period. Effective April 1, 1995, the FDIC Capital Maintenance Regulation (Part 325) established limits on the amount of certain DTAs that may be included in Tier 1 Capital for risk-basked and leverage capital purposes for state, nonmember banks. Under the Part 325, specifically section 325.5(g), for regulatory purposes, DTAs that are dependent upon future taxable income are limited to the lesser of: (1) the amount of such DTAs that the institution expects to realize within 1 year of the quarter end report date, based on its projection of future taxable income for that year, or (2) 10 percent of Tier 1 Capital before certain deductions are included.
Fannie Mae and Freddie Mac	Fannie Mae and Freddie Mac are shareholder-owned corporations with government charters. The organizations play a critical role in the U.S. home mortgage market by purchasing home mortgages from original lenders, repackaging them as mortgage-backed securities (MBSs), and either selling or holding them in their investment portfolios. Fannie Mae and Freddie Mac purchased about 80 percent of all new home mortgages in the United States during 2008, and their combined investment portfolios held mortgage assets valued at $1.5 trillion as of June 30, 2008.
Financial Holding Company	A financial entity engaged in a broad range of banking-related activities, created by the Gramm-Leach-Bliley Act of 1999. These activities include: insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, issuing or selling securitized interests in bank-eligible assets, and generally engaging in any non-banking activity authorized by the Bank Holding Company Act. The Federal Reserve Board is responsible for supervising the financial condition and activities of financial holding companies.
Nonaccrual Status	The status of an asset, often a loan, which is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status.

Glossary of Terms

Term	Definition
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. North Houston's peer group included insured commercial institutions with assets between $300 million and $1 billion. Madisonville's peer group included insured commercial institutions with assets between $100 million and $300 million and two or fewer full-service banking offices and not located in a metropolitan statistical area.
Preferred Shares	Preferred shares (or stock) are a special equity securities having characteristics of both equity and debt instruments. Preferred shares are senior in priority to common shares, but subordinate to bonds. Preferred shares typically do not have voting rights, but the shares often have priority over common shares in the payment of dividends and upon liquidation. Preferred shares may carry a dividend that is paid prior to any dividends to common stockholders.
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.
Risk-based Capital Rules	Appendix A to Part 325—*Statement of Policy on Risk-Based Capital*—defines the FDIC's risk-based capital rules. Appendix A states an institution's balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to broad risk categories according to the obligor or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the four risk categories are added together and this sum is the risk-weighted assets total that, as adjusted, comprises the denominator of the risk-based capital ratio. The institution's qualifying total capital base is the numerator of the ratio.

Glossary of Terms

Term	Definition
Section 23A of the Federal Reserve Act	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	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 Consolidated Reports of Condition and Income data submitted by banks.

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
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CPP	Capital Purchase Program
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
DTA	Deferred Tax Asset
FBOP	First Bank of Oak Park Corporation
FDI	Federal Deposit Insurance
FHFA	Federal Housing Finance Agency
FHLB	Federal Home Loan Bank
GSE	Government Sponsored Enterprises
IDFPR	Illinois Department of Financial and Professional Regulation
MOU	Memorandum of Understanding
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
OTTI	Other-Than-Temporary Impairment
PCA	Prompt Corrective Action
TARP	Troubled Asset Relief Program
TDB	Texas Department of Banking
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

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

May 19, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft Draft Audit Report Entitled, Material Loss Review of North Houston Bank, Houston, Texas and Madisonville State Bank, Madisonville, Texas (Assignment No. 2010-014)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of North Houston Bank, Houston, Texas (North Houston) and Madisonville State Bank, Madisonville, Texas (Madisonville) which failed on October 30, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on May 6, 2010.

The Report concludes North Houston and Madisonville failed because their Boards of Directors and management did not develop and implement adequate risk management practices pertaining to its investment securities, particularly Fannie Mae and Freddie Mac preferred stock; its significant concentration in commercial real estate loans (CRE), which were deteriorating in quality; and its loan participations from its affiliates. North Houston and Madisonville were two wholly-owned subsidiaries of First Bank of Oak Park Corporation (FBOP), a privately-held holding company in Oak Park, Illinois. In addition to North Houston and Madisonville, FBOP owned six national banks and partially owned another state chartered non-member bank in Illinois. The combined assets of North Houston and Madisonville represented only 3% of the total assets of the banks of FBOP. The entire FBOP failed when several of the national banks became undercapitalized.

The FDIC and the State of Texas Department of Banking (TDB) provided ongoing supervisory oversight through regular onsite examinations, visitations, and offsite monitoring. The Office of the Comptroller of the Currency closed the national banks and TDB closed North Houston and Madisonville on October 30, 2009, because the institutions were unable to raise sufficient capital to support their operations. DSC worked cooperatively with OCC, the Federal Reserve Board, and TDB in the coordinated supervision of FBOP and its subsidiary institutions.

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